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Touche Ross planning strategies: Tax Equity and Fiscal Responsibility Act of 1982;

Touche Ross & Co.;

TOUCHE ROSS PLANNING STRATEGIES

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

TOUCHE ROSS & CO. UNITED STATES/ TOUCHE ROSS INTERNATIONAL

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Touche Ross & Co. United States/Touche Ross International
New York

Touche Ross Planning Strategies: Tax Equity and Fiscal Responsibility Act of 1982

CONTENTS

Introduction

Just twelve months ago, the nation was hailing the enactment of the 1981 Economic Recovery Tax Act. The largest tax cuts in U.S. history were scheduled to reduce federal revenues by $750 billion over the five years following passage.

That was 1981. In 1982, a recession, unfulfilled economic expectations, and especially towering, projected deficits have replaced euphoria with caution and concern. And, for the fourth time in less than seven years, investors and businesses must come to grips with another major piece of tax legislation.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA, as it will be referred to in this booklet) represents an attempt to redress the economic balance presumably upset by the 1981 Economic Recovery Tax Act (ERTA). Interestingly, while the entire major tax policy shift represented by ERTA was contained in 194 pages of statute (as reprinted in the 1981 conference committee report), this year's tax provisions—the partial scaleback of benefits coupled with increased excise taxes, "loophole closers", and many new provisions to improve compliance—required 322 pages of statutory language. Of the $750 billion given up by the government in 1981-1986, TEFRA takes back approximately $215 billion in the five years after its enactment.

The new law does not lend itself to planning in the same fashion as ERTA; many of its provisions are written in the style of "Thou Shalt." However, there is still much planning to be done—either with respect to the substantive provisions of the Act or to its transition rules under which various sections do not come into effect for differing periods of time. In this booklet, we have tried to highlight the areas susceptible to advance planning, and in many instances we indicate what the nature and results of that planning might be.

One cautionary note as you begin reading: this booklet, though not small, is still only a "highlights" publication. *Many* areas of TEFRA are not even mentioned in these pages. With respect to other subjects that are included here, Touche Ross is publishing further material (booklets, newsletters, etc.) targeted at specific industry groups and covering TEFRA provisions of particular importance to each industry.

Finally, no booklet can answer all the questions about the implications of TEFRA for your investments or business; nor can it help you plan within the context of your specific circumstances. Your Touche Ross tax consultant can—and the obvious implication of all this is: we are here to help.

1

The Individual Taxpayer

Points to Consider

- A new, expanded alternative minimum tax (AMT) replaces current minimum taxes and can have a dramatic impact on a much broader range of taxpayers.
- Many traditional tax-saving techniques can backfire in the event the AMT applies. Intelligent planning becomes even more important.
- Uncle Sam will pick up less in the way of medical costs beginning in 1983. Availability and coverage of medical insurance become more important for some.
- Taxpayers should consider paying all possible medical expenses and health insurance premiums in 1982. In 1983, the threshold for deductibility of these expenses increases.
- Additional consideration should be given to medical reimbursement plans. The new 5 percent floor will cause most taxpayers to have no tax deduction for medical expenses (except in the case of significant, unreimbursed expenses).

Alternative Minimum Tax

The new law repeals the minimum taxes, but imposes a new, more comprehensive alternative minimum tax that increases the likelihood a taxpayer will pay the AMT. It is conservatively estimated that the new provision will affect 300,000 noncorporate taxpayers.

Under prior law, a noncorporate taxpayer could be subject to both an add-on minimum tax and an alternative minimum tax, in addition to the regular tax. The add-on tax was imposed on certain tax preference items if the sum of those items exceeded the greater of half the regular tax or $10,000. The old alternative minimum tax was imposed at a two-step graduated rate on gross income, less all regular deductions, plus two preference items. It was payable to the extent the AMT exceeded the regular tax.

TEFRA establishes a flat tax of 20 percent on the amount by which "alternative minimum taxable income" exceeds $30,000 ($40,000 on a joint return and $20,000 for married couples filing separately, and for estates and trusts). If that tax is greater than the regular tax for the year, the greater amount, reduced only by a limited foreign tax credit, is the tax liability for the year.

The calculation of alternative minimum taxable income now begins with adjusted gross income (AGI), which is determined with no deduction for net operating losses. Deductions are made for selected itemized deductions, a modified NOL deduction, and certain amounts taken into income by beneficiaries of trusts.

Some of the selected itemized deductions for the AMT are exactly those allowed for the regular tax and subject to the same limitations: charitable contributions, casualty losses, estate taxes, and wagering losses to the extent of winnings. The others are adjusted or subject to different limits. Medical expenses are allowed only in excess of 10 percent of AGI (compared to 5 percent for the regular tax). Only housing interest on loans used to acquire the taxpayer's principal residence (or a dwelling used by a family member) and nonhousing interest to the extent it does not exceed qualified net investment income are deductible for the AMT. Other itemized deductions (such as state and local taxes and excess interest) provide no benefit if the alternative minimum tax applies.

Caution: Qualifying housing interest does not include interest or debt incurred on a residence after purchase. Therefore, it will not be possible to shelter nonhousing interest through the use of a second mortgage, because this interest will itself be considered nonhousing interest and subject to the deduction limit. This applies to debt incurred after June 30, 1982.

The determination of the AMT deduction limit on nonhousing interest, such as interest on bank and auto loans or credit cards, follows some detailed rules which can greatly affect the ultimate tax paid. Income from investments used to calculate the limit includes not only interest, dividends, royalties, capital gains, and rents that the taxpayer receives directly, but also any share of income received from a limited partnership interest or Subchapter S corporation in which the taxpayer does not participate in management. Expenses directly related to the production of this investment income are netted against the income to produce the limit on nonhousing interest. Further, for purposes of the AMT, interest on indebtedness incurred to acquire or carry a limited partnership or Subchapter S interest is not allowable in computing adjusted gross income, so it is fully subject to the net investment income limitation.

The next step in determining alternative minimum taxable income is to add back eleven specific tax preference items. These items include: the bargain element of exercised incentive stock options; interest and dividends excluded under the $100 dividend exclusion; the all-savers exclusion and 15 percent net interest exclusion (1984); certain accelerated depreciation on real and personal property; the 60 percent exclusion on net long-term capital gains; and certain expenditures for intangible drilling costs, mining exploration, start-up circulation costs for newspapers and magazines, and research and experimentation. The last four items will not be tax preferences if the taxpayer elects to amortize them over a ten-year period for regular tax purposes.

An individual paying the new AMT for a taxable year will not lose the use of nonrefundable tax credits for which no benefit is received in the year. For example, if an individual has $10,000 of regular tax liability before credits and $5,000 of investment credit, but would have a tax liability of $8,000 for the year by reason of the alternative minimum tax, the $5,000 credit would result in only a $2,000 tax benefit (the difference between $10,000 and $8,000). Thus, the remaining $3,000 credit would become a carryback or carryover to other taxable years.

If the AMT applies, the net operating loss deduction for 1983 and thereafter is subject to two sets of rules depending upon whether the loss arose in a taxable year beginning after 1982. If it arose in 1982 or before, the loss may be carried over in full against alternative minimum taxable income; however, use of the carryover may trigger the old add-on minimum tax because pre-1983 preferences that were deferred will be subject, when used, to the add-on minimum tax. For a net operating loss that arose after 1982, alternative minimum taxable income cannot be offset by the portion of the loss resulting from tax preference items in the loss year, or by itemized deductions that would not have been taken into account in computing minimum taxable income in the loss year. While the treatment of loss carryovers was readily stated in one sentence in the Act, we anticipate substantial regulatory verbiage in the future to explain how one actually determines the portion of a loss attributable to preference or non-preference items.

The new provisions generally apply to taxable years beginning after 1982.

GAUGING THE EFFECTS OF THE AMT

The new AMT can apply in certain situations with unexpected vigor and can greatly upset traditional tax-saving techniques. First, note Tables 1-1 through 1-4 to see how AMT can change from 1982 to 1983 using identical facts. The taxpayer could be a typical salaried executive who has invested in a real estate limited partnership as a modest tax shelter. The shelter works well under 1982 law. Under 1983 law there is an increase in tax of over 50 percent. The increase is even more dramatic—over 200 percent—if the executive sells some investment property (realizing a $10,000 capital gain) to get cash to exercise incentive stock options (with a bargain element of $20,000). Taxable income would increase $4,000 ($10,000 gain less 60 percent deduction), but the AMT would increase $5,000 as shown in Tables 1-5 through 1-7.

PLANNING IDEAS

What if the executive has already exercised the incentive stock options when he realizes he might have to pay AMT? He or she could consider selling the stock. This disposition ends the stock transaction's tax-preferred status, but it also eliminates the bargain element as a preference item.

Assume, however, the executive appreciates his AMT liability only when he prepares his return the following April—can post-year-end planning produce a retroactive cure? Possibly. The conference report states: "It is intended that the . . . preference not apply where there is an early disposition of the stock. . . ." If disposition in the next year would be a disqualifying one, there is at least some basis for claiming the prior year AMT is not applicable. (There are also a number of potentially unhappy other tax consequences of such early sale—the situation must be carefully reviewed.)

Close examination of Examples 1 and 2 also shows that some tax-planning techniques could backfire in 1983 or later if the AMT arises. For instance, suppose the executive follows normally sound tax planning and prepays his winter real property tax installment and pays his January state income tax installment in December. This lowers his current regular tax, but, because no deduction is allowed for state and local taxes in the AMT calculation, the *total* tax paid is not reduced. The executive will have lost the use of cash with no tax benefit in the current year. To make matters worse, if the AMT turns out not to be applicable in the next year, those state and local taxes paid in December will not be available to reduce the next year's regular federal tax. Obviously, any tax-saving techniques will have to be viewed as to their effect both on the regular tax and the AMT. For instance, accelerating charitable contributions *would* have the desired effect.

Another Strategy. Because interest from tax-exempt bonds is not treated as a tax preference item, such interest remains free of minimum tax and therefore the bonds may produce a higher after-tax return than other "sheltered" investments with an equivalent stated yield.

Medical Expenses

For many taxpayers, it will now become more expensive to be sick. Under prior law, an itemized deduction is allowed for medical expenses, not reimbursed by insurance, that exceed 3 percent of a taxpayer's adjusted gross income. Drugs and medicines (rather broadly defined) may be included in those medical expenditures, but only to the extent they first exceed 1 percent of adjusted gross income. And, half of medical insurance premiums are deductible without regard to the 3 percent floor, up to $150. Any remaining premiums spill over into other medical expenses. All of these rules will change under TEFRA.

First, and most important, for years beginning after 1982, the 3 percent floor is raised to 5 percent of adjusted gross income, before any medical expense is deductible. While this may not appear particularly significant, it represents a 66⅔ percent increase in the nondeductible floor, which will indeed be significant for those taxpayers suffering from long-term illnesses whose costs are not completely covered by medical insurance.

The separate deduction of up to $150 for medical insurance premiums is repealed for years beginning after 1982, though medical insurance premiums do remain a medical expense subject to the new 5 percent floor.

Finally, for years beginning after 1983, the deduction for medicine and drugs will no longer be subject to its own separate 1 percent floor. However, the definition of medicine and drugs will be tightened so that it covers only prescription drugs and insulin. (We still think a case could be made for deducting the cost of aspirin consumed while filling out one's tax return, on the grounds that costs incurred in the determination of a tax are deductible; however, the IRS might not see it that way.)

An illustration comparing the new provisions, using a $40,000 adjusted gross income level, and looking at the rules for 1982 and

Table 1-1. Alternative Minimum Tax Example 1

	1982 Rules		*1983 Rules*	
Gross income				
Compensation	$100,000		$100,000	
Dividends and interest	5,000	$105,000	5,000	$105,000
Partnership losses:				
Depreciation, etc.[a]	$ 17,000		$ 17,000	
IDC	8,000	25,000	8,000	25,000
Adjusted gross income		$ 80,000		$ 80,000
Itemized deductions				
State and local taxes (income, property, sales)	$ 10,000		$ 10,000	
Home mortgage	15,000		15,000	
Charitable contributions	10,000		10,000	
Miscellaneous	3,000		3,000	
Nonhousing interest	10,000	48,000	10,000	48,000
Tentative income		$ 32,000		$ 32,000
Less: Personal exemptions		4,000		4,000
Zero bracket amount		3,400		3,400
Taxable income		$ 24,600		$ 24,600

[a]Assume excess accelerated over straight-line depreciation is $7,000.

Table 1-1. Alternative Minimum Tax Example 1 (continued)

	1982 Rules	*1983 Rules*
Tax (before credits)	$ 4,037	$ 3,656
Investment tax credit	2,000	2,000
Regular tax (before 15% minimum tax)	$ 2,037	$ 1,656
Minimum tax (see Exhibit 1)	750	0
Regular tax	$ 2,787	$ 1,656
Alternative minimum tax (see Exhibits 2 and 3)	0	2,744
Total	$ 2,787	$ 4,400

Table 1-2. Exhibit 1: 1982 Add-On Minimum Tax

Preferences:	
Excess depreciation	$ 7,000
IDC	8,000
Total	$15,000
Less exemption	10,000
	$ 5,000
Add-on minimum tax @ 15%[a]	$ 750

[a]Repealed for 1983 and later.

Table 1-3. Exhibit 2: 1982 Alternative Minimum Tax

Gross income	$105,000
Less: All deductions	73,000
	$ 32,000
Plus preferences: Adjusted itemized deductions	0
Alternative minimum taxable income	$ 32,000
Less exemption	20,000
	$ 12,000
Tax @ 10%	$ 1,200
Less regular tax	2,787
Alternative minimum tax	$ 0

Table 1-4. Exhibit 3: 1983 Alternative Minimum Tax

Adjusted gross income		$80,000
Less alternative minimum tax itemized deductions:		
Home mortgage interest	$15,000	
Charitable contributions	10,000	
Miscellaneous	3,000	
Nonhousing interest (limited to investment income)	5,000	33,000
		$47,000
Plus preferences:		
Excess depreciation	$ 7,000	
IDC	8,000	15,000
Alternative minimum taxable income		$62,000
Less exemption		40,000
		$22,000
Tax @ 20%		$ 4,400
Less regular tax		1,656
Alternative minimum tax		$ 2,744

EXAMPLE 2

Table 1-5. Alternative Minimum Tax Example 2
(Same as Example 1, plus $10,000 long-term capital gain and $20,000 bargain element of ISO)

	1982 Rules	*1983 Rules*
Tax (before credits)	$5,197	$4,696
Investment tax credit	2,000	2,000
Regular tax (before 15% minimum tax)	$3,197	$2,696
Minimum tax (see Exhibit 2)	750	0
Regular tax	$3,947	$2,696
Alternative minimum tax (see Exhibits 4 and 5)	0	6,704
Total	$3,947	$9,400

Table 1-6. Exhibit 4: 1982 Alternative Minimum Tax

Gross income	$115,000
Less all deductions	79,000
	$ 36,000
Plus preferences:	
Adjusted itemized deductions	0
Capital gain exclusion	$ 6,000
Alternative minimum taxable income	$ 42,000
Less exemption	20,000
	$ 22,000
AMT @ 10%	$ 2,200
Less regular tax	3,947
Alternative minimum tax	0

Table 1-7. Exhibit 5: 1983 Alternative Minimum Tax

Adjusted gross income		$84,000
Less alternative minimum tax itemized deductions:		
Home mortgage interest	$15,000	
Charitable contributions	10,000	
Miscellaneous	3,000	
Nonhousing interest (limited to investment income)	10,000	38,000
		$46,000
Plus preferences:		
Excess depreciation	$ 7,000	
IDC	8,000	
Capital gain exclusion	6,000	
ISO bargain element	20,000	41,000
Alternative minimum taxable income		$87,000
Less exemption		40,000
		$47,000
Tax @ 20%		$ 9,400
Less regular tax		2,696
Alternative minimum tax		$ 6,704

1984 (when the new provisions are fully effective), is shown in Table 1-8. Assume medical insurance premiums are $400, prescription drugs $450, nonprescription drugs $150, and other medical expenses are $3,000.

We suspect the need to review medical insurance costs and availability of a deduction is obvious. A substantial majority of individuals do not claim itemized deductions, and the changes in these provisions will appear, to them, academic. But, taxpayers with chronic illnesses, and particularly those suddenly encountering large medical bills, can find the 5 percent AGI floor a burden.

Similarly, year-end medical bills should be paid in December rather than January this year, as a general rule, if there is any likelihood 1982 medical expenses will be at a deductible level.

Finally, employers will find a medical reimbursement plan a more valuable fringe benefit, and possibly one that can be used to advantage in contract negotiations or union bargaining. Insured plans are permitted to be discriminatory; self-insured ones are not.

Table 1-8

	1982		*1984*	
Insurance premiums		$ 150		
Drugs: Prescription	$ 450		$ 450	
Other	150			
Less 1% AGI	(400)			
Drugs included in medical expenses	$ 200			
Other medical expenses	3,000		3,000	
Excess insurance premiums	250		400	
	$3,450		$3,850	
Nondeductible floor	(1,200)	2,250	(2,000)	$1,850
Deductible medical expenses		$2,400		$1,850

Casualty Losses

At present, there is a $100 floor before any nonbusiness casualty loss unreimbursed by insurance may be deducted (casualty losses include, generally, losses from fires, thefts, storms, accidents). The floor was included in the law essentially to avoid passing on to the government part of the cost for the "$100 deductible" feature of many casualty insurance policies.

Effective for years beginning after 1982, the nondeductible portion of casualty losses rises to 10 percent of adjusted gross income, but the $100 floor for each casualty also remains in the law. Thus, each casualty in a year must first be reduced by $100; the remaining amounts, in the aggregate, must exceed 10 percent of AGI before *any* loss is deductible.

For a limited class of casualties occurring in a Presidentially designated disaster area, taxpayers may elect to deduct the loss either in the year of occurrence or the preceding taxable year. If such an election is made, it will be 10 percent of the *prior* year AGI that provides the nondeductible floor, thus giving taxpayers some limited planning room. Note that for a 1983 disaster, it will be permissible to elect the loss deduction in 1982, based on 10 percent of 1982 AGI.

2
The Corporate Taxpayer

Points to Consider

- Financial institutions with tax-exempt portfolios have until December 31, 1982, to restructure portfolios in reaction to new rules for obligations acquired in 1983.
- Corporations planning construction of nonresidential real property within the next few months should be certain construction begins before the end of this year to avoid the application of new capitalization rules on construction period interest and taxes.
- Accurate estimation of income, and proper estimated tax planning, are even more important as Congress raises the amount of tax which must be paid during the year to avoid penalties.
- Seasonal businesses will need to consider a new exception to estimated tax penalties, which may help them pay less estimated tax.

Corporate Tax Preferences

All corporations, with the exception of those electing Subchapter S, have been subject to a 15 percent add-on minimum tax on certain tax preferences. This will continue (unlike the situation for individuals), but certain changes discussed below have also been made to restrict the tax benefits derived from particular items. The preference items of a Subchapter S corporation are not changed by TEFRA; they continue to be passed through to individual shareholders, subject to whatever special rules (such as alternative minimum tax) may apply under the individual tax provisions.

Rather than increasing the present 15 percent rate on certain corporate preferences, however, the Act generally reduces the tax benefit of those items by 15 percent. To prevent the combination of the add-on minimum tax and the 15 percent reduction in specific deductions from reducing the tax benefit from a corporate taxpayer's marginal dollar of preference by more than the current effect of the add-on minimum tax, only 71.6 percent of specified deduction items will be subject to the add-on minimum tax. Conversely, because noncorporate taxpayers are still eligible to deduct these preference items in full, the entire amount of those items is potentially subject to the new 20 percent alternative minimum tax.

The 71.6 percent number is not pulled from thin air; its derivation is spelled out in a lengthy, small-print footnote in the Senate Finance Committee report on the bill. In the interest of our readers' intellectual well-being, that discussion is not paraphrased here.

The 71.6 percent factor is calculated for a corporation subject to the top corporate tax rate of 46 percent and paying more than $10,000 in regular corporate tax. The result is that corporations with taxable income under $100,000 could receive more than the intended benefit from operation of the 71.6 percent factor.

Unless otherwise indicated, the changes are effective for taxable years beginning after 1982.

CAPITAL GAIN ON REAL ESTATE

The tax law now "recaptures" as ordinary income some of the depreciation previously taken on real estate, if the property is sold at a gain. Depending upon the type of real property and upon the period held, the remainder of the gain on real estate may be treated as a capital gain even though attributable to prior year depreciation. The portion of gain treated as ordinary income will be increased by 15 percent of the additional amount which would be ordinary income if personal property depreciation recapture rules were being applied to the gain.

One of the preferences currently subject to the 15 percent add-on minimum tax is $^{18}\!/_{46}$ of corporate net capital gains. To avoid undue restrictions on the real estate capital gain preference, the 71.6 percent factor discussed previously is applied in this instance to $^{18}\!/_{46}$ of the remaining 85 percent of the gain which would have been ordinary income if personal property depreciation recapture rules applied. This works out to approximately 28 percent of the remaining 85 percent of the gain.

Real estate investment trusts (REITs), being tax conduits similar to mutual funds, present interesting and unique problems in applying these rules. A REIT is taxed like a regular corporation on capital gains it retains, and its shareholders are taxed on capital gains distributed. Therefore, a REIT will be subject to the ordinary income treatment (increased by 15 percent) on appropriate gains, but not on amounts paid out as capital gain dividends. For those, corporate shareholders treat their share of recapture property gain as subject to these new corporate preference rules; individual shareholders treat the entire capital gain distribution as subject to the new alternative minimum tax provisions.

This section is effective for sales or other dispositions in taxable years ending after 1982. Post-1982 collections on pre-1983 installment sales should, therefore, be exempt from the new rules.

DISC DEFERRABLE INCOME

Fifty percent of certain taxable income of a domestic international sales corporation (DISC) may, under prior law, be deferred, with the other 50 percent taxable to DISC shareholders as though it had been distributed on the last day of the DISC taxable year. Under the Act, for taxable years beginning after 1982, the amount of DISC income which may be deferred is reduced to 42.5 percent; the remaining 57.5 percent will be taxed as though distributed. The Act is unclear about whether it is the taxable year of the DISC or its corporate shareholder(s) which must begin after December 31, 1982, but the answer to this question will be important to calendar-year corporations having a DISC with a January 31 year end.

BAD DEBT RESERVES OF FINANCIAL INSTITUTIONS

Certain financial institutions are entitled to bad debt deductions in excess of those which would be allowed based upon prior actual bad debt experience. The bad debt reserve deduction for financial institutions will, under TEFRA, be reduced by 15 percent of that excess.

This same "excess" deduction is a preference item subject to the 15 percent add-on minimum tax. As discussed above, in order to avoid unduly reducing the benefit from this tax preference, only 71.6 percent of the excess amount will hereafter be treated as such a preference.

Strategy. The allowable percentage rate for commercial banks eligible to use the percentage method of computing bad debt reserves is 1 percent for 1982 and is scheduled to decrease to 0.6 percent for years beginning after 1982. This coincides with the 15 percent reduction in bad debt deductions. It is, therefore, doubly important for commercial banks to consider taking full advantage of the allowable 1 percent in computing their 1982 addition to bad debt reserves.

INTEREST EXPENSE ALLOCABLE TO TAX-EXEMPT OBLIGATIONS

For years, the Internal Revenue Code has provided that interest and other expenses are not deductible to the extent allocable to tax-exempt income. Although many financial institutions have tax-exempt obligations in their investment portfolios, they have not generally been subject to disallowance of their normal operating or interest expense. For taxable years beginning after 1982, however, 15 percent of interest expense will not be deductible to the extent allocable to tax-exempt obligations acquired after December 31, 1982. The interest expense considered to be allocable to tax-exempt obligations will generally be based on the ratio of average adjusted basis of tax-exempt obligations to average adjusted basis of all assets. There is no indication at present whether such averaging will be determined weekly, monthly, or on some other basis throughout the year.

Strategy. It is important to note that although the 15 percent disallowance will apply to all interest incurred in taxable years beginning after 1982, it is only allocable to tax-exempt obligations acquired after December 31, 1982. Tax-exempt obligations acquired before 1983 will not be included in the determination of the disallowed interest expense, no matter how long they are retained in the investment portfolio. Financial institutions subject to this new provision should thoroughly examine their investment portfolio before January 1, 1983, so that any desired trades in tax-exempt obligations may be completed before then.

INTANGIBLE DRILLING COSTS (IDCs)

"Integrated" oil companies (in general, those corporations which do not qualify for percentage depletion because of the extent of their refining or marketing activities) will find the deduction for IDC reduced by 15 percent. *It is presently unclear how dry hole costs are to be treated for this purpose.* The nondeductible portion will be amortized ratably over a 36-month period beginning with the month in which the costs are paid or incurred. No investment tax credit will be allowable with respect to capitalized costs. The 36-month amortization schedule would appear to impose an enormous record-keeping burden on the integrated oil companies which may be incurring IDC in every month of the year. Expenditures incurred after December 31, 1982 in fiscal years ending after that date are subject to the 15 percent reduction.

MINERAL EXPLORATION AND DEVELOPMENT COSTS

Presently, mineral exploration and development costs are generally deductible as incurred. Only 85 percent of such expenditures incurred in taxable years ending after 1982, will continue to be deductible when paid or incurred. The remaining 15 percent will be capitalized and depreciated under the five-year ACRS rules, and will be eligible for the investment tax credit.

DEPLETION FOR COAL AND IRON ORE

The present percentage depletion deduction for iron ore and coal (including lignite) will be reduced by 15 percent to the extent it exceeds the adjusted basis of the property. This change is effective for taxable years beginning after 1983. The 15 percent reduction in percentage depletion applies to all corporations except Subchapter S. Individuals, estates, and trusts will continue to be eligible for the full statutory percentage depletion rate.

71.6 percent of the "excess" depletion over the adjusted basis of the property will continue to be a preference item subject to the 15 percent add-on minimum tax.

POLLUTION CONTROL FACILITIES

Certain pollution control facilities are eligible for rapid write-off; that is, 5-year straight-line amortization. For any such facilities placed in service after 1982, only 85 percent of the basis will be eligible for the 5-year straight-line amortization. The remaining 15 percent will be eligible for depreciation under longer ACRS lives, but will not be subject to the real estate capital gain rules discussed previously.

Again, to avoid undue restriction on pollution control facilities, only 71.6 percent of the excess of the 5-year amortization over normal depreciation will be treated as a preference subject to the existing 15 percent add-on minimum tax.

CHILD CARE FACILITIES

Rapid amortization of child care facilities is no longer an item of tax preference subject to the 15 percent add-on minimum tax.

Acceleration of Corporate Income Tax Payments

A number of provisions are included in the new law to accelerate the payment of income tax by corporations. First, prior law permitted corporations to pay only 50 percent of their remaining tax liability on the original due date of the return (2½ months after year end). TEFRA will require corporations to pay the full remaining amount due. Second, the amount of estimated tax payments required to avoid underpayment penalties is increased from 80 to 90 percent of the current year's liability.

Possibly because Congress recognized some of the difficulties inherent in estimating income during the tax year, the penalty on underpayments of estimated tax between 80 and 90 percent of the actual tax is only 75 percent of the usual penalty, providing that estimated payments are at least 80 percent of the actual liability. In addition, TEFRA provides a new, elective method for annualizing the income on which estimates may be based for taxpayers with highly seasonal income. To qualify, a taxpayer (such as a typical retailer) must earn 70 percent of its income in a period of six consecutive months. Under prior law, the annualization exception would cause a taxpayer with most of its income earned early in the year to overpay its tax liability. Obviously, it was not relied upon. Under the new exception, the income used for estimated tax payments for a period is annualized using the seasonal pattern reflected in the taxpayer's average income for the same period in the prior 3 years. Thus, current income is taxed in the same seasonal pattern in which it has historically been earned.

The Secretary of the Treasury is directed to amend the regulations to improve the computation of annualized taxable income at interim dates during the tax year. Examples of areas to be covered are LIFO indexes, temporary liquidations of a LIFO layer, the deferred gross profit in installment method revolving charge accounts, and intercompany adjustments in a consolidated return.

The provisions concerning corporate tax payments are effective for years beginning after 1982.

Construction Period Interest and Taxes

Under prior law, individuals, personal holding companies, and Subchapter S corporations are required to capitalize interest and real property taxes incurred during the construction period of real property (other than low-income housing). Generally, the capitalized construction period interest and taxes are amortized over 10 years. Corporations other than personal holding companies and Subchapter S corporations were not required to so capitalize although they could elect to under another section of the law.

Generally, TEFRA extends the mandatory capitalization of interest and taxes to all corporations. However, the provisions will not apply to the construction of *any* residential real property.

One major question raised by the new rule is how to determine the interest to be allocated to a construction period, especially when borrowings are not specifically designated as applying to a particular project. It is expected that the regulations, yet to be issued, will be similar to rules already promulgated by the Financial Accounting Standards Board, which generally require capitalization of the total interest expense that could have been avoided had funds not been expended for construction.

The "construction period," for purposes of this rule, begins on the date that construction of the building begins and ends on the date that the building is ready to be placed in service or held for sale. Generally, actual construction must commence to start the period, so that planning, architectural studies, or obtaining a building permit will not by themselves be qualifying activities.

For the construction of nonresidential real property begun after 1982, the changes for interest and taxes paid or incurred are effective for taxable years beginning after 1982. There is a special transitional rule for hotels, motels, hospitals, and nursing homes that would postpone the application of the rules if a written construction plan was in existence on July 1, 1982, if governmental approval has been requested by that date, and if construction starts before January 1, 1984.

If a corporation is already planning to begin construction of a building in 1983, accelerating the beginning of construction to 1982 should be considered to avoid the application of these rules.

3
Corporate Acquisitions

Points to Consider

- **Congress has attempted to close certain perceived abuses dealing with corporate acquisitions. It has succeeded, in part; failed, in part; and opened, in large part, planning opportunities that may not have been intended.**
- **Family corporations expecting to pass control to a younger generation need to plan more carefully than ever. Substantial advance planning will be necessary to avoid gain recognition at the corporate level on distributions of appreciated property in redemptions.**
- **Acquisitions and liquidations of recently purchased corporations can occur without recapture gains and tax attribute losses by not electing asset purchase treatment. The price for this result is a carryover basis in the newly acquired assets.**
- **The complex new rules for treating a stock purchase as an asset purchase can be a double-edged sword. They provide traps for the unwary and many planning options for the informed.**
- **Recapture gains will be triggered in both asset sales and stock purchases treated as acquisitions. Purchase prices should be adjusted to reflect whether the buyer or the seller will assume the tax liability.**
- **The anti-bailout provisions will have a significant effect on estate planning. Gifts of stock to a spouse or child should be given greater consideration, taking into account the combined amounts of the unified estate and gift tax credit.**

The subject of corporate acquisitions is one of the most complex in tax law. There are taxable purchases and tax-free reorganizations; what is an acquisition to one party is a disposition to another; the change in ownership can be via a transfer of stock or of assets; it can be primarily to transfer ownership and management to a new generation in the same family; and each variation on the theme can produce different tax consequences to the present and future owners.

The 1982 Act makes the most comprehensive and sweeping changes in this area of law in, perhaps, 30 years or more. The new provisions attack at least one U.S. Supreme Court decision of the 1930s, a host of other judicial decisions, and a perception by Congress and Treasury that development of this body of law has not necessarily been to their liking.

There is no way to keep such a subject simple. What we have done in this chapter is to illustrate by example the major perceived abuses Congress has addressed in its new law, discuss the application of TEFRA rules to those examples, and examine other planning routes to the same goal.

That Congress did a less-than-perfect job with these new provisions is not surprising. They were not introduced for the first time until May 6 of this year; only one day of hearings was held on each side of the Capitol; and the new rules are generally effective for transactions after August 31, 1982—or less than four months from original introduction to effective date.

We believe the consequences of these new provisions will take years to unravel.

Prior Law

To understand the highly technical changes in the rules for mergers and acquisitions, it is first necessary to understand the prior rules and the perceived abuses which prompted the changes.

REDEMPTIONS

Under prior law, if a corporation redeemed the stock of its shareholders, the shareholders would recognize capital gain or loss. Generally, if the stock was redeemed using appreciated property, the distributing corporation would recognize gain on the distribution. Gain would not have been recognized by the corporation on the distribution, however, in two cases:

1 A distribution of appreciated property redeeming all of the stock of a 10-percent-or-more shareholder who held the stock for at least one year.

2 A distribution of stock or obligations of certain 50-percent-or-more owned corporations actively engaged in a trade or business.

These two exceptions did not apply to "recapture" of certain prior tax benefits.

An example of a use of these rules which Congress intended to change is as follows:

Example. A, an individual, wanted to buy a building owned by Corporation X. X wanted to sell the building but wanted to avoid recognizing the gain on the sale. Accordingly, A and X agreed to have A buy 10 percent of the stock of X, which X would redeem in 13 months in exchange for the building. Under a literal reading of prior law, X recognizes no gain on the transfer of the building because the building was used to terminate the entire interest of a 10 percent shareholder.

Under the new law a corporation will not be able to avoid the recognition of gain using this type of transaction. Instead, the distributing corporation must recognize gain to the extent the fair market value of the building exceeds the distributing corporation's adjusted basis. The rule that the distributing corporation would have used to avoid recognizing gain is modified by requiring (1) that the distribution qualify as a "partial liquidation" and (2) the redeemed shareholder hold a 10 percent interest in the corporation for at least five years (or, if less, the entire period of the corporation's existence).

Another example of the use of these rules which Congress intended to eliminate is as follows:

Example. Corporation P wanted to sell all the stock of its wholly owned subsidiary, Corporation S. After Corporation B agrees to buy the stock of S, P and B agree that if B acquires shares of P stock equal in value to all of S's stock, then P will redeem its own stock in exchange for all of the stock of S. Under a literal reading of prior law, P could avoid gain on the disposition of S's stock because P used the stock of a 50-percent-or-more owned corporation to redeem its own shares.

Under the new law, P will have to recognize gain on the distribution since the stock of S is being distributed to a corporate shareholder in a qualifying redemption, rather than as a dividend. Further, if B were not a corporation, P would recognize gain unless B had held the stock for at least five years before the redemption.

CERTAIN STOCK PURCHASES TREATED AS ASSET PURCHASES

Under prior law, a corporation could buy the stock of a target corporation and treat the purchase as an asset acquisition. This treatment was achieved by purchasing 80 percent of the target's stock within one year and adopting a plan to liquidate the target within two years after the purchase. The complete liquidation of the target could have been accomplished over three years. Thus, a total of five years could have elapsed from the date of the purchase of target stock until the final liquidating distribution was made.

The liquidation of the target into the purchaser did not result in gain or loss to either corporation, except for recapture gains. The purchaser's basis in the target's assets was determined by allocating the cost of the purchased stock, with certain adjustments, to the assets in relation to their fair market value. If the transaction was treated as an asset purchase, the target would recognize recapture gains and other tax attributes would not carry over to the purchaser. In addition, if the target had subsidiaries of its own, these second-tier subsidiaries would not have to be liquidated. Accordingly, there would be no basis step-up for the subsidiaries' assets, no recapture for these assets, and no termination of attributes.

These rules are illustrated by the following example. Corporation P purchased all of the stock of Corporation S and had to decide whether the liquidation of S would have been advantageous. S had two subsidiaries: one had been in existence for many years and the second was relatively new and operated at a substantial loss. P had sufficient net operating loss carryovers to absorb the recapture income resulting from the liquidations only if S and its older subsidiary were liquidated. Accordingly, S's older subsidiary was liquidated into S. This liquidation produced no gain or loss to either S or the liquidated subsidiary. Thereafter, S was liquidated into P.

In the liquidation of S into P no gain or loss was recognized by either corporation (with the exception of recapture by S). P received a new basis in the assets acquired from S, including the assets of S's older subsidiary and the stock of the newer subsidiary. If P and S filed a consolidated return, the loss carryovers of the P group could offset the recapture income resulting from S's complete liquidation. S's newer subsidiary remained in existence and its tax attributes were unchanged. In addition, during the period from the date of the stock purchase until the final liquidating distribution (up to five years later) P's affiliated group could use S's tax attributes.

Under the new law, P will have to decide within 75 days after acquiring 80-percent control of S whether to elect to treat the purchase of S's stock as a purchase of all of S's assets in a liquidating sale. Also, an election made by P for one subsidiary is deemed made for all subsidiaries as well. Furthermore, P cannot use its losses or carryovers to offset S's recapture.

PARTIAL LIQUIDATIONS

Under prior law, a partial liquidation of a corporation produced capital gain or loss to the shareholders. In addition, the distributing corporation would not recognize gain on the distribution (except for recapture gains).

To qualify as a partial liquidation, a distribution had to meet a number of technical requirements. It must have resulted from either: (1) the contraction of the distributing corporation's business or (2) the cessation of one of the distributing corporation's businesses, which had been actively conducted by it for at least five years. Under IRS advance ruling policy, a contraction of the business must result in a 20 percent reduction in gross assets, gross revenues, and employees. When the distribution consisted of proceeds from the sale of assets, gain on the sale would have been recognized to the corporation.

Under prior law, if P and S filed a consolidated return, P could achieve the benefits of a complete liquidation without the detriments by only partially liquidating S. For example:

As in the preceding example, Corporation P purchased the stock of Corporation S and must decide whether to treat the purchase as an asset acquisition. If it does so, S would recognize recapture income and S's tax attributes (for example, carryovers) would be eliminated. Although P and S filed a consolidated return, allowing P's carryover to offset S's recapture income, the carryovers were insufficient to absorb all recapture items that would result from a complete liquidation of S (that is, depreciation recapture, investment tax credit recapture, and income from the disposition of the stock of any wholly owned foreign subsidiary or domestic international sales corporation). Thus, P decides to partially liquidate S.

Under the plan of partial liquidation, S will distribute 95 percent of its operating assets to P. Because the corporations file a consolidated return, P will not recognize any gain from the partial liquidation. As in a complete liquidation, P will get a new basis in S's distributed assets. S will not recognize gain or loss on the distribution, except any recapture; but, unlike a complete liquidation, investment tax credit recapture is eliminated and other recapture is deferred under the consolidated return rules. Further advantages of the partial liquidation over complete liquidation include: (1) survival of the tax attributes of S; (2) deferral of LIFO recapture; and (3) no income from the disposition of the stock of any controlled foreign corporations or domestic international sales corporations, if the stock remains in S.

Under the new law, partial liquidations only apply to distributions to noncorporate shareholders. Thus, S's distribution to P would be treated as a dividend (assuming sufficient earnings and profits). S will not recognize any gain on its distribution, but P will not get a new basis in the assets received from S.

The New Law in General

REDEMPTIONS

Under the new law, capital gain or loss treatment will still be available to shareholders whose shares are redeemed. On the other hand, a redeeming corporation must meet new conditions to avoid gain recognition if appreciated property is used for the redemption. The distribution of appreciated property to a corporate shareholder in redemption of its stock will generally cause the redeeming corporation to recognize gain. If the distribution does not qualify as a redemption, the distributing corporation will not recognize gain.

A redemption of a noncorporate shareholder will also cause the redeeming corporation to recognize gain unless the shareholder directly or indirectly held at least 10 percent of the corporation's stock for five years (or, if less, the entire period of the corporation's existence) and either of two other conditions are met. The first condition is that the distribution qualifies as a partial liquidation under the new law. The second condition is that the distribution consist of 50 percent or more of the stock or obligations of certain controlled corporations.

These changes generally apply to distributions occurring after August 31, 1982. Special transition rules are provided for ruling requests pending before the IRS, recent stock acquisitions, certain distributions of timberland, and certain distributions in compliance with court orders.

CERTAIN STOCK PURCHASES TREATED AS ASSET PURCHASES

The new law repeals the provisions of prior law that treated the purchase of stock of a target corporation followed by the complete liquidation of the target as an asset purchase. As under prior law, however, the purchaser may treat a stock acquisition as an asset purchase, but the purchaser must elect this treatment within 75 days after purchasing 80 percent control. If the election is made, the target will be treated as having sold all of its assets to a new corporation in connection with a complete liquidation in which no gain or loss will be recognized (other than recapture). As under prior law, the new bases of the target's assets will equal the purchaser's basis in the target stock. The purchaser's basis in the target stock is increased for the liabilities and other relevant items and is allocated among the target's assets in accordance with future regulations.

Even though an actual election is not made, the purchasing corporation will be deemed to have made an election if it acquires assets from the target (or the "target's affiliates") within the period beginning one year before and ending one year after the stock acquisition date (known as the "consistency period"). An election will not be deemed to have occurred if the sale was in the ordinary course of the target's trade or business or if the property was acquired in a nonrecognition transaction.

There is a further consistency requirement for all stock acquisitions from the same affiliated group. An election by the purchaser regarding the first target purchased applies to the acquisition of all target affiliates during the consistency period.

These changes are generally effective for stock purchases occurring after August 31, 1982. Special transition rules apply to certain financial institutions and recent acquisitions.

PARTIAL LIQUIDATIONS

Taxpayers' ability to use the partial liquidation provisions of the Code has been substantially curtailed. The provisions will no longer apply to distributions to corporate shareholders. Distributions of property to a corporate shareholder other than in a redemption will be treated as a dividend (assuming sufficient earnings and profits). The shareholder will get a basis in the property equal to the lesser of the distributor's basis or the property's fair market value. As under prior law, a noncorporate shareholder will recognize gain or loss on a redemption, including redemptions in partial liquidation. The distributing corporation will recognize gain on the distribution in a partial liquidation of appreciated property to a noncorporate shareholder unless the shareholder has held 10 percent of the corporation's stock for at least five years (or, if less, the entire period of the corporation's existence). The noncorporate shareholder's basis in the distributed property will be fair market value regardless of whether the distribution is treated as a dividend or as a redemption.

The changes generally apply to distributions made after August 31, 1982. Special transition rules, however, apply to recently approved and pending ruling requests, some recently adopted plans, and special types of corporations.

REORGANIZATIONS CONSTITUTING CHANGES IN FORM

As under prior law, one type of tax-free reorganization is "a mere change in identity, form, or place of organization." Court decisions have permitted this type of reorganization to include the combination of several operating companies into one. Only under this type of reorganization was a transferor not required to close its taxable year, and post-reorganization losses could be carried back to prior taxable years of the transferor. The new law permits this type of reorganization only for a single entity, effective for transactions occurring after August 31, 1982 (except for plans of reorganization adopted before that date and completed by December 31, 1982).

USE OF HOLDING COMPANIES TO BAIL OUT EARNINGS

Prior law restricted a shareholder of commonly controlled corporations from obtaining capital gain treatment on the sale of his stock in one controlled corporation (Corporation X) to another (Corporation Y). Without the restriction, the sale would provide an easy opportunity for the shareholder to bail out earnings and profits from X at capital gain rates. The restriction operated by treating the sale to Y as if the shareholder received a distribution from X whose stock was sold in exchange for his or her X stock. If the distribution to the shareholder satisfied the redemption tests, the shareholder would receive capital gain treatment on the sale; otherwise, the distribution would be treated as a dividend.

To avoid this rule, shareholders borrowed funds secured by the stock of a controlled corporation. They then transferred the stock to a newly formed holding company (Newco) in exchange for all of Newco's stock and the assumption by Newco of the liability for the borrowed funds. Under prior law there was uncertainty about whether the redemption tests or the tax-free incorporation rules controlled. Further, even if the redemption test controlled, any dividend treatment would be determined by looking to the earnings and profits of Newco, which would have no earnings and profits.

The new law obviates this abuse by applying the redemption tests to this transaction. In addition, the earnings and profits of the corporation whose stock is transferred will be deemed to be distributed to Newco. Therefore, Newco will be treated as having sufficient earnings and profits for dividend distribution treatment. There is an exception to this new provision for bank holding companies.

Another way a shareholder may have attempted to bail out earnings at capital gain rates was to cause a controlled corporation to make a nontaxable distribution of preferred stock to existing shareholders. Under the old law, this preferred stock would be tainted, causing the shareholders to recognize ordinary income on most dispositions. A shareholder could avoid ordinary income, however, by the tax-free incorporation of a holding company that would issue its own common and preferred stock in exchange for the stock of the controlled corporation. The holding company's stock would not be tainted and could be subsequently sold at capital gain rates.

Under the new law, the preferred stock issued by the newly incorporated holding company can be tainted. The transaction will be viewed as if money had been distributed instead of stock, and therefore, a determination will be made whether the deemed receipt of money would constitute a dividend. For the purposes of this test, the earnings and profits of the corporation whose stock is transferred will be deemed to be distributed to the acquiring company.

The new law applies to transfers occurring after August 31, 1982, except for certain transfers already before the Federal Reserve Board for approval.

ATTRIBUTION RULES

Under prior law, the determination of whether preferred stock or other property received by a shareholder in a reorganization (or other similar transaction) had the effect of a distribution of a dividend was determined without application of the "attribution" (that is, constructive ownership) rules. When property other than stock was distributed, there was uncertainty about whether these attribution rules would be applied.

For example, if a father exchanges all his common stock for preferred stock of the issuing corporation and his son was the only other common shareholder, the preferred stock would not be tainted because the attribution rules did not apply.

The new law has made the attribution rules specifically applicable to the receipt of preferred stock and to the receipt of any other property received in reorganizations, spin-offs, and tax-free incorporations.

These changes are effective for transactions involving the receipt of preferred stock or property which occurs in taxable years ending after August 31, 1982.

WAIVER OF FAMILY ATTRIBUTION

Under prior law, family attribution could be waived in determining whether a shareholder had completely terminated his stock interest in a corporation. The new law allows trusts and estates to waive family attribution, provided that the entity and its beneficiaries who are family members each sign the appropriate waiver agreement. Only family attribution may be waived; the waiver rules do not extend to waivers of attribution to and from entities.

This change applies to distributions occurring after August 31, 1982.

Planning for the Future

REDEMPTIONS AND PARTIAL LIQUIDATIONS

1. Family corporations expecting to pass control to a younger generation need to plan now. Until August 31, 1983, corporations can use appreciated property to redeem the stock of 10-percent-or-more shareholders who had acquired their stock after 1980 and before May 1982 without the recognition of gain except for recapture gains.

2. If the transition rule in (1) does not apply, a sale of assets should be considered. If the children of the founders of the corporation own less than 20 percent of the corporation's stock, they can form their own new corporation to purchase the assets of their parents' corporation. The new corporation should make an installment purchase of all the assets of the old corporation, except for cash and buildings. If the sale by the old corporation is accomplished under a plan of complete liquidation, and the old corporation distributes all of its assets (including the proceeds

from the sale) within 12 months, then with the exception of recapture, it will recognize no gain or loss. The parents will recognize capital gain or loss in the liquidation. They will report the gain on the receipt of the cash and the building in the year of distribution, but the gain on the installment sale will be reported only as the installments are paid.

After the liquidation, the parents can lease the building to the new corporation. Rental payments must approximate a fair rental value. Depreciation on the buildings will be computed using a fair market value basis and will flow directly to the parents. Any investment credit on the leased property should be passed through to the new corporation to avoid the investment credit limitation on noncorporate lessors, and the credit can be taken into account in the rental arrangement. Safe harbor leasing is unavailable on any of the leased property because the lessors are not corporations.

3. A possible alternative to the sale exists if the distributing corporation is in the process of acquiring a new plant, office building, or other major asset that is equal in value to the stock of the noncorporate shareholder to be redeemed. The corporation should use this new property to redeem the shareholders before placing it in service. Since the property is new, its fair market value will equal its basis in the hands of the distributing corporation; thus, the corporation will recognize no gain in the redemption. In addition, since the property will not have been placed in service, there should be no recapture. Thereafter, the redeemed shareholder can lease the property received to the distributing corporation, as described in (2) above.

4. Under the new law, if a purchasing corporation acquires 80 percent of the stock of a target corporation and elects for asset-purchase treatment, the target can redeem any individual minority shareholders using appreciated property without recognizing gain (other than recapture). The redeemed shareholders would recognize capital gains on the redemption, and they can lease the property to either corporation, as described in (2) above.

5. The new law can be used to advantage when a business decides to cut back on plant activities or divisions. Under the new provisions, a corporation may redeem certain noncorporate shareholders using appreciated property and avoid gain recognition, provided the distribution and redemption qualifies as a partial liquidation. The partial liquidation requirement will be satisfied by a 20 percent contraction of the business or by a cessation of one of two or more active trades or businesses. In addition, the corporation will not recognize gain on a distribution to certain

10 percent shareholders if 50 percent or more of the stock of a controlled corporation is distributed.

6. If the corporation still wants to redeem its shares, it should use installment notes. There is no gain to the distributing corporation, and the shareholders can spread their gain over the period of the installment obligation as the payments are received. In many instances, the notes can be spread over a 15-year period, paying only interest until the 15th year, when the principal is also paid off.

7. A corporation can also redeem its shares for cash. The corporation can refinance the mortgages on its property and use the proceeds from the refinancing to redeem its shareholder.

8. Another alternative is to have the corporation establish an employee stock ownership trust (ESOT). The corporation receives a deduction for funding the ESOT and the ESOT can then purchase the shares of the retiring shareholder. The shareholder will receive capital gain or loss on the sale of the shares.

CERTAIN STOCK PURCHASES TREATED AS ASSET PURCHASES

1. Under the new law, the purchasing corporation must make an election to obtain a new basis in the assets of a recently acquired subsidiary. If the purchasing corporation does not make the election and decides instead to adopt a plan of liquidation for the subsidiary, the liquidation will produce no gain or loss to either corporation. In addition, the subsidiary's tax attributes will be carried over to the purchasing corporation. The purchasing corporation will not get a new basis in the subsidiary's assets, but the recapture provisions will not apply. This is especially important to financial institutions, since there would be no recapture of the bad debt reserve or reduction in other tax attributes.

2. Under the new law, the purchasing corporation that elects asset-purchase treatment will be unable to offset the recapture income of the target corporation with the purchasing corporation's net operating loss carryovers. This inability results from the intent of Congress that the deemed sale of assets be treated as having occurred on the day before the purchasing corporation actually acquired control of the target. However, there is no prohibition against the target recognizing all of its losses by an actual sale of loss assets before the purchase of its stock. The target's losses or net operating loss carryovers can be used to offset its own recapture gains in its final tax return.

3. The "consistency period" (one year before and after the date

of acquisition) can be a trap as well as a planning tool. If, during the consistency period, the purchasing corporation acquires any asset from the target corporation (or from a target affiliate), the purchasing corporation will be deemed to have made the election. The deemed election will not be triggered, however, if the asset was acquired in the ordinary course of the target's business or has a carryover basis in the hands of the purchaser.

4. A trap exists for a corporation that purchases the stock of a target and unwittingly purchases an asset from the target (or a target affiliate) during the consistency period. The asset purchase will trigger an unwanted deemed election.

5. The deemed election, however, is a two-edged sword which may be used as a planning tool. If the 75-day period for making the election expires and the purchasing corporation regrets not having made the election, the purchase of any asset from the target (or a target affiliate) will trigger a deemed election. The Internal Revenue Service, however, can deny the deemed election or allow it to stand. If the Service denies the deemed election, the purchasing corporation will have been able to acquire a particular asset from the target affiliate in which it wanted a new basis without triggering an election. If the Service allows the deemed election, the 75-day period will have been expanded to a 1-year election period.

6. If a purchasing corporation intends to elect asset purchase treatment with respect to a target and its subsidiaries, the purchaser should be aware that recapture gains on the deemed liquidations should affect the purchase price. In addition, if the assets purchased include the stock of a target subsidiary, the deemed election will apply to the subsidiary's assets and recapture will result. In negotiating either acquisition, the purchasing corporation and the selling corporation's shareholders should adjust the purchase price to reflect this treatment. In this regard, it appears that Congress intended that the recapture gains will be used as an adjustment to the price paid for a target's stock. The adjusted purchase price is to be allocated to the basis of the target's assets.

7. It may prove to be more advantageous to the purchasing corporation to acquire assets rather than stock of the target. If assets are acquired, the purchase price may be specifically allocated among the assets in the purchase agreement. By contrast, in a stock purchase and election, the purchase price of the stock is to be allocated among the target's assets in accordance with uncertain future regulations.

8. If all the assets of a target corporation, including the stock of any target subsidiaries, are sold, the new law deems an election to have been made with respect to the subsidiaries. Thus, both the target and its subsidiaries must pay taxes caused by recapture on their final returns—thereby reducing the amount distributable to the shareholders in liquidation. This reduction should be taken into account by the shareholders in negotiating the sale price of the target's assets.

ANTI-BAILOUT PROVISIONS

The anti-bailout provisions will have a significant effect on estate planning. Gifts of stock to a spouse or child should be given greater consideration, taking into account the combined amounts of the unified estate and gift tax credit. In addition, donations of stock can still be made to charities and subsequently redeemed by the corporation, providing a charitable contribution deduction to the shareholder.

4

The Business Taxpayer

Points to Consider

- Taxpayers will be able to apply investment credits against only 85 percent of tax liability over $25,000 in taxable years beginning after December 31, 1982, rather than the present 90 percent.
- Taxpayers will now have to choose between full depreciation of cost basis and the full investment credit. In many cases, the choice will not be obvious, or even easy.
- Rehabilitation of historic structures may still be the greatest tax shelter available, but it's not quite as great.
- Tax regulations on the completed-contract method will become more restrictive. Fiscal-year contractors must carefully review the regulations redefining contract completion date. The redefinition may cause estimated tax underpayments for the current year.
- Original issue discount will now correspond to the actual economic accrual of interest. Ratable deduction/inclusion over the life of the bond will no longer occur.
- New rules eliminating accelerated depreciation on facilities financed with industrial development bonds make them less attractive for corporations.
- The TEFRA effective dates and a proposed "sunset" of the "small issue" provisions place a premium on the prompt negotiation and closing of contemplated IDB projects.

ACRS Depreciation Tables

ACRS deductions have been computed using the 150 percent declining-balance method with a switch to straight-line at the most advantageous time. The scheduled acceleration of the ACRS cost-recovery tables to 175 percent declining balance in 1985 and to 200 percent declining balance in 1986 has been repealed.

Investment Tax Credits

LIMITATION ON INVESTMENT TAX CREDIT

For the calendar 1982 or fiscal 1983 taxable year, the first $25,000 of income tax, as well as 90 percent of the tax liability in excess of $25,000, may be entirely offset by investment tax credits. The Act reduces, from 90 percent to 85 percent, the offset of investment credits against income tax liability exceeding $25,000, effective for taxable years beginning after 1982.

BASIS ADJUSTMENT

Before the Act, depreciation could generally be computed on 100 percent of the full cost of depreciable property, even though the investment tax credit, the energy credit, or certified historic structure rehabilitation tax credits had also been taken on that cost. Basis was reduced by the full amount of nonhistoric structure rehabilitation investment tax credits. Lessors could pass investment credits through to lessees without having to reduce asset basis, or lessees their rent deductions.

The Act retains the full reduction in the basis of noncertified historic rehabilitation projects. However, it also provides for a basis reduction in any asset by 50 percent of the investment tax credit and the energy and certified historic structure rehabilitation tax credits. The reduction also applies to credits claimed on qualified progress expenditures. These basis reductions will generally apply to all calculations dependent upon asset basis, such as depreciation, determination of gain or loss, etc. For purposes of computing depreciation recapture upon the sale of personal or real property, the basis reduction is treated as depreciation previously allowed.

If some or all of an investment credit is subsequently recaptured because of a premature disposition of the asset, its basis is increased by 50 percent of the recaptured credit immediately before the event resulting in the recapture.

In determining corporate earnings and profits, prior depreciation is calculated using the straight-line method over appropriate periods. For such computation, the asset basis is determined without any reduction for 50 percent of the investment credit. If the investment credit cannot be utilized in the year the underlying property is placed in service or within the carryback or carryforward period, a deduction is allowed for 50 percent of the unused credits, in the year following their expiration. If a taxpayer dies or ceases to exist before the end of the normal carryforward period, a similar deduction for 50 percent of the unused credits will be allowed in the final return of that taxpayer. As you can see, it is intended that the deduction discussed in this paragraph be allowed only in situations where the expiring credit initially resulted in an asset basis reduction for 50 percent of the credit.

Because of an elective procedure discussed below, situations may arise where some credits taken in a year result in asset basis reduction and others do not. If such credits are only utilized in part before expiring, guidance will be required from Treasury as to which credits will be considered to have been used and whether further deductions will be permitted.

ELECTION TO AVOID ADJUSTMENT

Congress recognized that it would be unfair to require reduction of basis by taxpayers currently unable to utilize investment credits because of net operating losses, the 85 percent-of-tax liability limitation, etc. TEFRA therefore includes a procedure allowing a taxpayer to avoid basis adjustment by electing a reduced investment credit. Electing taxpayers will be allowed a 4 percent investment credit on 3-year ACRS property instead of the normal 6 percent, and an 8 percent investment credit on other ACRS property instead of the normal 10 percent.

This election can be made property by property, but only for the year the property is placed in service. The election may be revoked with IRS consent, which is unlikely to be liberally granted. A similar election may be made on qualified progress expenditures but again, only in the first year of such expenditures, and that election will apply in future years to subsequent expenditures on the same property. The election for partnership property will be made at the partnership, not the separate partner, level.

The implications of all the above rules are hardly obvious. We present in Table 4-1 a listing of present values of tax benefits and compare the use of full investment credit and depreciation on less than full cost, with the use of reduced ITC and depreciation on 100 percent of cost. In computing present values, we have assumed that the tax benefits are realized at the end of the year. This will not be the case in many instances, but it is used in these examples for consistency.

Table 4-1 shows that the investment credit "give-up" for full depreciation was, presumably, determined using a 46 percent marginal corporate tax rate and the assumption that the ITC could be utilized in full the first year. Under those circumstances, for a $10,000 asset, and utilizing a 14 percent opportunity cost for

Table 4-1
(Asset Cost $10,000)

Five-Year Life							
	10% Investment Credit			*8% Investment Credit*			*Expense*
Year	*Depreciation on $9,500*	*Tax Benefit @ 46% Plus 10% ITC*	*Present Value @ 14%*	*Depreciation on $10,000*	*Tax Benefit @ 46% Plus 8% ITC*	*Present Value @ 14%*	*Present Value @ 14%*
1	1,425	1,656	1,452	1,500	1,490	1,307	
2	2,090	961	740	2,200	1,012	779	
3	1,995	918	619	2,100	966	652	
4	1,995	918	543	2,100	966	572	
5	1,995	918	477	2,100	966	501	
			3,831			3,811	4,035
Comparable amount @ 30% marginal rate			2,804			2,730	2,631
Comparable amount @ 20% marginal rate			2,162			2,054	1,754

Three-Year Life							
	6% Investment Credit			*4% Investment Credit*			*Expense*
Year	*Depreciation on $9,700*	*Tax Benefits @ 46% Plus 6% ITC*	*Present Value @ 14%*	*Depreciation on $10,000*	*Tax Benefit @ 46% Plus 4% ITC*	*Present Value @ 14%*	*Present Value @ 14%*
1	2,425	1,716	1,505	2,500	1,550	1,360	
2	3,686	1,696	1,305	3,800	1,748	1,345	
3	3,589	1,651	1,114	3,700	1,702	1,149	
			3,924			3,854	4,035
Comparable amounts @ 30% marginal rate			2,742			2,635	2,631
Comparable amounts @ 20% marginal rate			2,004			1,874	1,754

present value purposes, the difference between the tax benefit present values is only $20 (0.2 percent of cost). Note, however, that for 3-year property, the 2-point give-up on ITC costs taxpayers $70 rather than $20 as with 5-year property. This is because the two provisions are not completely comparable: for 3-year property, the immediate surrender of two percentage points ITC only gets taxpayers an additional three percentage points of depreciation basis rather than the five percentage points obtained for 5-year property.

Not surprisingly, giving up ITC has a greater economic impact at lower marginal tax rates. The Touche Ross publication *Planning Under the 1981 Economic Recovery Tax Act* discussed this in some detail (pp. 48–50). The end result is that the lower the marginal rate, the more benefit there is to immediate utilization of the investment credit, even if that requires giving up part of the cost for depreciation.

Readers should remember there is one other alternative available for consideration—though it is a limited one. Under the 1981 law, the first $5,000 of asset acquisitions (rising to $10,000 annually starting in 1986) may be immediately expensed. While no ITC is permitted on such expensed property, the tax benefit does come all in the first year, assuming a sufficient income level. For a $10,000 asset, in 1986 or thereafter, the present value of the immediate write-off is $4,035—about $200 higher then either of the alternatives presented in the 1982 Act. Again, at lower marginal rates, the pendulum swings back toward substantial advantage from ITC utilization.

But what if the ITC cannot be utilized in the first year and must be carried over to some future time? In deciding between the two primary alternatives, it becomes necessary to determine the crossover point, or the year in which the present value of the ITC surrendered becomes less than the present value of tax benefits for the additional depreciation.

Table 4-2 shows the calculation of that crossover point for a 5-year $10,000 asset (for which the ITC give-up would be $200). It indicates that if the ITC is usable in the year of acquisition, the comparable present values are $20 in favor of full ITC rather than full depreciation—and, not coincidentally, this is the same result reached in a different manner on Table 4-1. If the ITC is not used until the second year, there is only a 1 dollar difference. If it is anticipated that the credit cannot be utilized until the third year, there is a $20 advantage to giving up the two percentage points of ITC in favor of full depreciation.

Table 4-2

Year	*Depreciation on $500*	*Tax Benefit @ 46%*	*Present Value @ 14%*	*Present Value of $200 ITC at End of Each Year*
1	75	35	30	175
2	110	51	39	154
3	105	48	33	135
4	105	48	28	
5	105	48	25	
			155	

Other crossover points are set forth below:

Life	*Marginal Rate*	*Crossover Year*
5 years	30%	6
5 years	20%	9
3 years	46%	5
3 years	30%	9
3 years	20%	12

Lessors may elect to pass investment credit through to lessees. The Act provides that the lessor's basis will remain intact, but that 50 percent of the investment credits passed through to the lessee will have to be recorded as income by the lessee—ratably over the ACRS recovery period for the property. Lessees may also elect a two percentage point reduction in the investment credit passed through to them, in which case they are not required to include any amount in income. If the lessee investment credit is recaptured, the income inclusions will be adjusted in accordance with regulations to be prescribed.

The ACRS depreciation rules, established by the 1981 Economic Recovery Tax Act, included certain "anti-churning" provisions to prohibit certain transfers of pre-ERTA property from becoming eligible for more liberal ACRS depreciation. The acquisition of property subject to anti-churning may still generate investment credit (subject to the used property limitation) but at the following, pre-ACRS rates:

Depreciable Life	*Percent of Credit*
3–5 years	3⅓
5–7 years	6⅔
7 years or more	10

Such property is also now subject to a basis reduction equal to 50 percent of the investment credit on it. Since the election to take reduced ITC applies only to "recovery property" (property depreciated under ACRS), and the purpose of the anti-churning rules was to prevent certain pre-1981 property from becoming recovery property, the ITC reduction election will not be available.

The basis reduction generally applies to assets acquired and placed in service after December 31, 1982. Unless "grandfathered" under the exceptions discussed below, qualified progress expenditures after 1982 will also be subject to basis reduction. Self-constructed assets would be similarly affected.

Property may be exempt from the basis reduction if:

1 It is constructed, reconstructed, erected, or acquired pursuant to a contract entered into after August 13, 1981, provided it was binding on July 1, 1982 and at all times afterward;
2 It is placed in service before 1986; and
3 The property is neither a public utility nor subject to a safe harbor lease.

An "integrated manufacturing facility" may also be exempt from the basis reduction if before July 1, 1982, the taxpayer had constructed, or entered into binding contracts for the construction of, more than 20 percent of the facility's cost. There are also somewhat more liberal transition rules for certain certified historic structure rehabilitation projects.

Completed-Contract Method of Accounting

Early in 1982, Treasury expressed concern to Congress about tax deferrals generated by companies utilizing the completed-contract method of accounting. Proposals were advanced to repeal the method, to continue its existence but require the using company to pay interest on the taxes deferred, and other variations. Touche Ross and other organizations testified to the Senate Finance Committee and the House Ways and Means Committee that the primary abuses perceived by Treasury could be solved by amendments to the regulations as opposed to the statutory change, and the final law adopts essentially that approach. The Act bestows on Treasury broad legislative authority to amend its regulations concerning the definition of contract completion, the severing and aggregating of contracts, and the allocation of costs to certain contracts.

CONTRACT COMPLETION DATE

The regulations will be amended to redefine the completion date of a contract in order to prevent deferral of completion for tax purposes by reason of contractual provisions that are merely incidental to the taxpayer's obligations under the contract. Treasury also intends to prevent unreasonable deferral of income obtainable by treating several contracts as a single one; for example, where the items to be constructed or manufactured under the contracts are independently priced and will be separately delivered or accepted deferral will not be permitted.

It is generally assumed that the development of proposed regulations is virtually complete, and that they will be issued shortly. The amended regulations will apply to any taxable year ending after 1982. If the completion-date amendments result in a contract considered to have been completed before the first taxable year ending after 1982, the Act provides that the completion date shall be considered to be the first day of such taxable year.

Assume, for example, a contractor with a fiscal year ending January 31, 1983, with a contract that under the old regulations was not considered as completed before February 1, 1982. Assume further that, under the amended regulations, such contract would be considered to have been completed before February 1, 1982. The Act provides that the income from such contract will be reportable as of February 1, 1982. This could create tremendous estimated tax problems because such facts will not become known until the regulations are issued (presumably in the fall of 1982). If this contractor is using any of the annualization rules for computing estimated taxes during the fiscal year ended January 1, 1983, there is a statutory gap as to relief from penalties for underestimating tax.

The transition rules for aggregating and severing contracts are more lenient. If, under the amended regulations, a contract would be considered to have been severed and completed prior to the first taxable year ending after 1982, the income from such contract will be reportable on the first day after 1982 on which any other severed contract of the same group is actually completed.

ALLOCATION OF COSTS

Treasury was concerned not only with the delay in reporting contract income but also the amount of income being deferred under the completed-contract method. Its position is that many costs incurred because of contracting activities, and deducted currently as period costs, should be allocated to contracts and the deduction deferred until the completion date. The Act provides for an amendment of the regulations to allocate to contracts those costs "incurred by reason of" the contracting activities of the taxpayer. The conference committee specifies that the following expenses will now be allocable to contracts and therefore not necessarily deductible in the year incurred:

- Bidding expenses on contracts awarded to the taxpayer
- Distribution expenses, such as shipping costs

- General and administrative expenses properly allocable to long-term contracts
- Research and development expenses that are either directly incurred under existing long-term contracts, or are incurred under an agreement to perform research and development
- Tax depreciation to the extent it exceeds financial statement depreciation (financial statement depreciation was already required to be treated as a contract cost)
- Pension and profit-sharing contributions representing current service costs, and other employee benefits
- Rework labor, scrap, and spoilage
- Percentage depletion exceeding cost depletion (There was already a requirement that cost depletion be allocated to contracts.)

Some of the above are more important to contractors than others. And, the impact on contractors of requiring many such costs to be allocated to contracts is known already, even in the absence of implementing regulations. The category of general and administrative expenses however is somewhat of a catchall. The Senate Finance Committee report is instructive as to the apparent direction of the regulations:

> . . . the committee intends that the Treasury will issue regulations that require additional costs to be allocated to extended period long-term contracts, i.e., those costs that directly benefit or are incurred by reason of the performance of extended period long-term contracts . . . of the taxpayer even though the same type of costs also benefit other activities of the taxpayer.

Contractors subject to the revised cost allocation rules should revise their cost accounting system to identify the additional costs and to ensure that no more than the minimum required is allocated to contracts.

The language in the Act requiring Treasury to issue regulations on allocation of additional cost to long-term contracts is ambiguous regarding the treatment of many of the listed costs. How will research and development expenses be directly attributed to particular existing contracts? Should credits on scrap sales follow charges for scrap and spoilage on particular contracts? How will tax depreciation be allocated to specific contracts? Even if some of the accounting concept problems are solved, significant additional record-keeping must result from any attempt to attribute period costs to individual contracts, particularly in situations where such costs as tax depreciation, over-ceiling bidding and research costs, and certain general and administrative expenses are not now attributed to such contracts.

The cost allocation rules apply to costs incurred in taxable years beginning after 1982, and only with respect to contracts entered into after that date. There is also a 3-year phase-in so that, for the taxable year beginning in 1983, only one third of such costs is allocable to contracts, in the taxable year beginning in 1984 two thirds are allocable, and in taxable years beginning in 1985 and thereafter the full amounts are allocable to applicable contracts.

It had been generally assumed that Treasury was aiming primarily at defense contractors. The Act reinforces this perceived bias in several ways. First, the cost allocation requirement applies only to extended-period long-term contracts, defined as any contract which the taxpayer estimates, at inception, will not be completed within two years of the commencement date. The commencement date is the first date on which a contractor incurs any costs allocable to such contracts. Bidding expenses or other costs incurred during the contract negotiations are excluded.

The Act also provides a more lenient rule for "construction" contracts: those for the building or construction of an improvement to real property or the installation of integral components of an improvement to real property. Examples include buildings, roads, dams, and similar property. A contract for the installation of elevators in a building is a construction contract, whereas a contract to manufacture elevators is not. If the same contract covers both the manufacture and installation of an elevator, its revenue and cost would have to be segregated between the manufacturing and the installation elements.

A construction contract is not subject to the revised cost allocation rule unless it is estimated, at inception, that it will take more than three years to complete, measured from the commencement date. Also, construction contracts in excess of three years are not subject to the revised cost allocation rules if the average annual gross receipts of the contractor for the three preceding years do not exceed $25 million. The $25 million includes receipts of related organizations as well as all trades and business of the taxpayer (even though some are not in the contracting field). Joint-venture gross receipts are also allocated to the joint venturers for purposes of the $25-million test.

There are many unanswered questions in the areas of the estimated contract completion date and the $25-million test. Since the completion date is to be estimated when the contract is entered into, what effect will unforeseen events have? Must contractors build into their time expectations work delays due to strikes, bad weather, subcontractor failure, or financial problems? What effect will change orders have? In measuring the $25-million amount, must a company include proceeds from the sale of capital assets? How will owner-purchased materials affect the $25-million test? Are gross receipts measured on a tax basis or a financial statement basis?

Although somewhat restricted, the completed-contract method is still a viable option for contractors, particularly those engaged in construction (as defined earlier). Those not presently using it should consider applying for permission to change. Proper planning is important because of the adjustments required. Defense contractors will have to plan for accelerated income tax payments.

GOVERNMENT CONTRACTS

While the mandated regulatory changes are for tax purposes, they will affect other aspects of business as well. There are two important considerations in administering government contracts that flow from the completed-contract changes and the resulting acceleration of tax payments over the next several years. First, a company pricing new contracts should consider increasing its profit objectives to offset the increased cost of money because of earlier tax payments.

Second, the changes in tax accounting are also considered changes in cost accounting practices under Department of Defense interpretation WG 81-25. Therefore, all contracts containing the cost accounting standards clause would be subject to adjustment as a result of the different level of state tax payments (an allowable cost for government contracts). However, since the level of allowable cost will increase, the increased cost cannot be passed on to the government, unless the government agrees the change is desirable and not detrimental to its interests. Since the change in accounting for taxes would increase the cost of government contracts, such a decision by a government contracting officer is not likely to be easily obtained.

Original Issue Discount

When bonds paying interest below prevailing market rates are issued, they are priced below face value at maturity so a buyer's net yield will equal the market rate. Under old law, the difference between the face value at maturity and the issue price, called "original issue discount" (OID), was deducted by the issuer and taken into income by the holder ratably over the bond's life. For instance, consider the following example:

Face amount of bond	$100,000
Stated interest, payable annually	11%
Term	4 years
Current market yield on similar bonds	14%

The amount a buyer should be willing to pay for this bond is the present value of the face amount to be received at maturity plus the present value of the stated interest payments. Based on the facts above, the price should be approximately $91,260, thus generating OID of $8,740. For tax purposes, it would have been recognized at approximately $182 per month, or $2,185 per year. Each annual payment of stated interest is $11,000, so total interest would have been $13,185 for each of the four years of the bond term.

The new law puts bonds with OID on a par with bonds paying stated interest at the prevailing rate. Instead of attributing an equal share of OID to each month, the new law recognizes it based on compound, stated annual interest. To compare the results using the two approaches, again consider the facts of our example. Under TEFRA, OID for the first year is as follows:

Price of bond	$91,260
Market yield rate	× 14%
Total yield	$12,776
Less interest coupons	(11,000)
First year OID	$ 1,776

Because OID is derived from the expected yield, total interest recognized under this approach cannot exceed that paid on a bond bearing interest at the rate prevailing at issuance ($12,776 in this example). By contrast, the total of interest paid and OID in the first example yielded more for the first year ($13,185 compared to $12,776).

Under the new rule, investment return for the subsequent periods will be based on the price of the bond plus the previously recognized OID, and so on for the life of the bond. Thus, the OID recognized for the life of the bond under the two methods will be as shown in Table 4-3.

Another major change in this provision is that OID is attributed to a holder on a daily basis (rather than monthly). For instance, assume a corporate bond is issued January 1, 1983 to one holder and transferred to another on June 13, 1983 (the 164th day of the year), and that both have taxable years ending December 31. Also assume OID for the year beginning January 1, 1983 (the "bond year" under the law) is $1,000. The original holder recognizes 163/365 × $1,000, or $447 of OID for 1983. The new holder takes the other $553 into income (202/365 × $1,000) for 1983.

The OID concept also is extended to noncorporate issuers other than natural persons. Tax-exempt bonds, U.S. Savings Bonds, and Treasury bills are, however, specifically excluded from these rules, so the extension is not as great as might first appear.

All amounts recognized as interest using the OID rules are treated as interest for other provisions of the Internal Revenue Code. For instance, the new withholding provisions for interest and dividends (discussed on p. 85) apply to OID.

Otherwise, the old OID rules are continued. For instance, if a subsequent holder pays more for the bond than its issue price plus previously accrued OID, the excess may be offset against OID income. Also, the new ratable-inclusion rules apply only to bonds with a maturity date more than one year after the issue date. When shorter-term bonds are sold or redeemed, however, the amount of gain which would have been OID will be taxed as interest income, not capital gain.

The new rules apply to bonds issued after July 1, 1982, unless issued later under a written commitment binding on that date and thereafter. Consequently, there is little planning to be done with respect to these provisions other than to be sure to take them

Table 4-3

Year	*Old*	*New*
1	$2,185	$1,776
2	2,185	2,025
3	2,185	2,308
4	2,185	2,631
Four-year totals	$8,740	$8,740

into account. Because the OID calculations are based on a "bond year," discount bonds may offer a slight advantage over those paying current rates more than once a year. Largely, however, the provision achieves its goal—discouraging the issuance of low- or zero-interest bonds.

Coupon Stripping

Because of technical holdings by the Internal Revenue Service, some taxpayers have been able to recognize losses by selling bonds after detaching the coupons. This was especially useful to banks since losses on bond transactions usually could offset their ordinary income. The technique worked as follows.

Company A owns a coupon bond for which it paid $100,000 which is now worth $90,000. Sold without interest coupons, the bond would bring only $60,000. Under pertinent rules, none of the cost of the bond is attributed to the coupons, so a $40,000 loss would arise in the current year if the bond were sold and the coupons retained.

Of course, much of the recognized loss would reverse in later years as the coupons were collected or sold, so the loss could be termed artificial.

The new rules affect "coupon stripping" two ways. First, the cost of a bond is allocated according to the relative fair market values of its elements. Thus, any loss on sale will reflect a real economic loss, not one that would reverse itself as coupons were collected.

For instance, continuing the example above, gain or loss would be calculated as follows:

Proceeds on sale of "stripped" bond	$ 60,000
Share of adjusted basis:	
$60,000/$90,000 × $100,000	66,666
Loss	$ (6,666)

The loss is a two-thirds share of the $10,000 decline the bond suffered before the "strip." Thus, a loss which will later be offset by interest received is no longer recognized.

The second effect of the new rules is to treat the excess of the maturity value over the selling price of a "stripped" bond or coupons as original issue discount. Thus, not only is the "stripper" denied an artificial loss, but the buyer may not defer recognition of the return inherent in the discount.

Unfortunately, from a taxpayer's perspective, the elimination of what Treasury perceives as an abuse is not the end of the bad news concerning this provision. The earliest use of coupon stripping was the sale of the coupons to accelerate income. Because the entire cost of the bond was allocable to principal, whatever price was received for the coupons was ordinary income. Thus, the sale of coupons was a very efficient way to recognize income in order to offset losses; for example, net operating loss carryovers due to expire. With a proportionate share of basis allocated to coupons under the revised rules, the potential income recognition is sharply limited. The transaction cost is also increased by the decline in value of the stripped bond which, if sold in a later year, would bring less now that these "naked" bonds are subject to OID income recognition rules.

These provisions are retroactively effective for "naked" bonds and for coupons "stripped" after July 1, 1982.

Targeted Jobs Tax Credit

The targeted jobs tax credit is extended for two years and will thus be available for qualified employees beginning work on or before December 31, 1984. Starting May 1, 1983, the credit is made available for summer employment of disadvantaged youths. Under this provision, employees can qualify only once for the credit.

The credit will be 85 percent of the first $3,000 in wages (as under prior law, the deduction for wages will be reduced by the amount of the credit). General assistance recipients of non-cash as well as cash payments will now qualify for certification, and involuntarily terminated CETA employees will be eligible for the credit through December 31, 1982. A number of other technical changes are made, including one permitting certifications on or before the day an employee begins work.

Strategy. The targeted jobs tax credit is an often overlooked benefit. Employers, especially those with needs for seasonal employees, should evaluate the potential impact of this entire subject, not just the new changes.

Tax-Exempt Obligations

In general, interest on certain state and local bonds, called industrial development bonds (IDBs), issued to build facilities not used by government agencies or public charities is not exempt from federal income tax. There are, however, significant exceptions to this rule for particular types of private facilities that benefit the public (for example, airports and pollution control facilities), and for IDBs that are part of a "small issue" (limited to $1 million, unless a $10 million limit is elected after meeting certain requirements). These exemptions, particularly for small issues, have been used increasingly in recent years, and TEFRA takes some first steps toward curtailing their availability.

The small-issue exemption is set to terminate for obligations issued after December 31, 1986, including those to refund obligations issued before that date. In addition, the $1 million small issue exemption may no longer be combined with other exceptions. For instance, if an IDB-financed $21 million airport project includes $20 million of public-use property and $1 million of private facilities, the $1 million small-issue exception cannot provide exemption for interest on bonds to build the private facilities. On the other hand, if the necessary election and reporting requirements are met, bonds subject to the $10 million category of small issues can still be used in combination with bonds exempt under other provisions.

Besides these general restrictions, a new provision eliminates the small-issue exemption where more than 25 percent of bond proceeds are used to erect or improve facilities for automobile sales and service, retail food and beverage service (not including grocery stores), or the provision of recreation or entertainment; or where *any* proceeds are used for a golf course, country club, hot tub or suntan facility, racetrack, or—yes, it's true—a massage parlor.

There are three major steps the Act takes to dampen activity in all tax-exempt bonds used to finance privately used facilities. First, approval of all projects by elected officials or the local voters will be required. One alternative is to hold a public hearing and have the project formally approved by the elected official or officials of the governmental unit sponsoring the issue and any having jurisdiction over the property where the financial facility is being built. Another is to submit the proposed financing to a referendum in the locality in which it is located. The first alternative does not require that the public hearing be taken into account by an approving official. It is expected, however, that the glare of publicity (including pressure from competitors of the proposed user of the facility) will cause local officials to consider whether the IDBs are an appropriate part of their local development programs.

The second major step the Act takes to reduce utilization of IDBs is to deny use of ACRS depreciation. Instead, the cost of any property financed by IDBs must be recovered using straight-line depreciation (with a half-year convention but no salvage value) over the standard ACRS recovery period (a longer recovery period may still be elected under the ACRS rules).

The third important restriction is a new requirement that the average maturity of an IDB issue cannot exceed 120 percent of the average economic life of the financed facilities. Although the statute contains no definition of "economic life," the conference report indicates an intent that pre-ACRS useful lives for depreciation (that is, the midpoint ADR life or the guideline lives under Revenue Procedure 62-21) be used as administrative guidelines. The economic life is to be determined case by case, however, and lives longer than the depreciation guidelines may be established for the particular principal user or users of a financed facility. This new provision adds yet another point of uncertainty to be resolved when floating an IDB issue.

Some increase in paperwork can be expected by issuers to produce reports to the IRS of all IDBs, student loan bonds, and bonds for most public charities, for all issuances after December 31, 1982. These reports are due by the 15th of the second month after the calendar quarter in which bonds are issued, and the information is intended, at least in part, to be used to develop future legislation on exempt issues.

In the midst of these restrictions on IDBs are two limited relief provisions for small issues. The first is *very* limited: In summing up the expenditures which count toward the $10 million small-issue limit, those qualifying for the research and development credit will not be counted.

The second relief provision is for the many state and local authorities that have been concerned with rulings by the IRS that small issues of various localities which are combined to improve marketing, etc., are treated as a single issue. (These "multiple-lot," "composite," or "umbrella" issues were restricted in Revenue Ruling 81-216). Effective upon enactment, issues will be considered separate unless the financed facilities are located in more than one state or have the same (or a related) principal user. For this rule, franchises or licensed operations are treated as related even though independently owned, so one group of issues could not benefit more than one store operating under a particular trade name. Also, issues which come under the special transition rule of Rev. Rul. 81-216 are not subject to this new rule.

The Act also includes a number of miscellaneous expansions of the categories of exempt IDBs and some loosening of the requirements for exempt issues used to provide home mortgage funds. The mortgage subsidy bond section would: (1) clarify certain rules as to arbitrage and non-mortgage losses; (2) allow mortgages to yield up to 1⅛ percent more than the interest rate on the bonds themselves; (3) provide that only 90 percent of the proceeds need be used for mortgages to first-time home buyers; (4) increase the maximum purchase price limit; and (5) make provision for cooperative housing.

New rules for taxing original issue discount (OID) on bonds, discussed earlier in this chapter, do not apply to tax-exempt obligations.

The most important response to the changes made by this Act is quick action on pending financing proposals. The effective dates of the various new restrictions leave limited room for maneuver, so it is important to be aware of them.

JULY 1, 1982

Property financed by bonds issued July 1, 1982, or later may not be depreciated using the ACRS tables. There are major exceptions to this rule:

- Property placed in service before December 31, 1982, is not restricted.
- If the property was the subject of a binding agreement to incur significant expenditures toward construction, reconstruction or rehabilitation, or actually was under construction, etc., before July 1, 1982, a taxpayer that is the "first user" of the property may use ACRS.
- If the bond financing is a refunding issue, ACRS may be used for depreciation prior to the date the refunding bonds are issued.

DATE OF ENACTMENT

Rules for "composite" issues, the restriction on the combination of the small-issue with other exemptions, new requirements for mortgage subsidy bonds, the "sunset" provision, the exclusion for research and development expenditures, and the miscellaneous-expansion provisions all are effective as of the date of enactment. (The eased first-time homebuyer requirement for mortgage subsidy bonds is retroactive and will apply to uncommitted funds from obligations issued after April 24, 1979.)

DECEMBER 31, 1982

- An exception to the July 1, 1982, effective date for depreciation restrictions applies, as noted above, to property placed in service before 1982.
- The restriction on the use of IDBs for auto dealerships, etc., applies to obligations issued after December 31, 1982.
- Public approval and reporting are required for obligations issued after 1982 unless the bonds are a refunding issue which does not extend the financing more than three years.

Quite obviously, most taxpayers will want to preserve ACRS depreciation either by checking to see if binding agreements existed or construction began before July 1, 1982, or by completing a project and placing it in service before the end of the year. Likewise, those financing auto dealerships, fast food outlets, recreation facilities, etc. will want to accelerate issuance of the bonds, if possible, to no later than December 31, 1982, to avoid the new restrictions.

What actions localities should take is much less clear. If a locality has based much of its industrial development program on the availability and attractiveness of IDBs, then prompt action to bring projects to completion is desirable. On the other hand, the new restrictions only limit the appeal of IDBs to taxpaying companies; IDBs are not eliminated as a development tool. Also, all things being equal, the restrictions should slacken the rate of issuance of IDBs, thus reducing the upward pressure on interest costs and improving the attractiveness of tax-exempt bonds issued by localities. Thus, a locality may not want to take any immediate action. It may be enough simply to take stock of the changes and reassess its plans as their impact becomes clearer.

5
Leasing

Points to Consider

- **Property that was acquired, or on which construction was begun or ordered under a binding contract, before July 2, 1982, can still be safe harbor leased without restrictions if placed in service before January 1, 1983.**
- **Due to restrictions on safe harbor leasing and finance leasing, old-style leveraged leases are comparably more attractive.**
- **Restrictions on how much a lessee may lease and on the benefits a lessor may buy can cause transactions to be delayed until late in a taxable year.**
- **Beginning January 1, 1984, safe harbor leasing will be replaced by "finance" leasing, with its own set of rules to learn and plan for.**
- **The lessee in safe harbor and finance leases must meet a 45 percent or 40 percent limitation on property that can be leased, and the lessor must meet a no-more-than 50 percent tax liability reduction test. The lessee test is more important because failure to meet the 45 percent or 40 percent test will result in disqualification of lease treatment.**

One of the ERTA depreciation changes hailed as a major advance when enacted last year was the introduction of so-called safe harbor leasing. Under this concept, the user of property that qualifies for investment credit can, in effect, sell the tax benefits associated with ownership (investment credit and depreciation deductions) to a third party while retaining its use and residual value. In the following discussion, *safe harbor* leases mean leases under the provisions of ERTA, as modified by TEFRA; *finance* leases mean the new lease concept introduced by TEFRA; and *true* leases mean leases that would have been treated, for tax purposes, as leases under the pre-ERTA rules—specifically including leveraged leases under the advance ruling guidelines issued by the IRS in 1975.

Before ERTA, whether a lease agreement was characterized for tax purposes as a lease or as a sale (that is, whether the lessee or lessor got the tax benefits associated with the property) was governed by a number of complicated court decisions and IRS rulings holding, essentially, that the party having the traditional benefits and burdens relating to the ownership of property is the owner for tax purposes. In practice, the complexity of modern lease financing makes this determination depend on the facts and circumstances of the particular transaction, and sometimes no clear answer is apparent. The safe harbor leasing provisions were intended to provide a method by which certainty of tax treatment could be reached by following the ERTA rules.

Safe Harbor ERTA Leases

As originally passed, the ERTA rules provided for two types of transactions. First, and more traditional, was a direct lease of property from a lessor to lessee, where lessor buys property from a third party and leases it to lessee. Although this transaction is similar to traditional leases, many factors used in court decisions for determining whether the transaction is a lease no longer applied. For example, residual value, nominal purchase option price, fair market rental, and positive cash flow to the lessor are specifically disregarded in determining whether a transaction qualifies as a lease under ERTA rules.

The second, less traditional but more commonly used, transaction is a sale and leaseback (also known as a tax benefit transfer), under which the lessee-user purchases property to be used in his business. Within 90 days after the property is placed in service, the lessee-user and a "lessor" enter into a paper sale/leaseback agreement. For federal tax purposes only, the lessee sells the property to that lessor for a downpayment and a note, and simultaneously leases the property back. During the lease term the rental payments and the note payments offset each other. Therefore, the only cash transferred in the transaction is the downpayment which is based on the present value of the tax benefits being sold.

TEFRA Leases

Numerous changes were made in the safe harbor lease rules by TEFRA, mostly aimed at scaling back the benefits available through this technique. Further, significant changes which were made to the traditional leasing rules will create a new type of lease (called a finance lease) that will be available after 1983. First, a look at the revisions in safe harbor leases:

"GRANDFATHERED" SAFE HARBOR LEASING

Certain property can still be safe harbor leased without regard to the TEFRA changes. If the lessee acquired, began construction, or entered into a binding contract for the purchase of property after 1980 and before July 2, 1982, and if the property is placed in service before 1983, the TEFRA changes to safe harbor leasing will not apply. There are also separate transitional rules dealing with auto manufacturing equipment, mass transit vehicles, passenger aircraft, certain turbines and boilers of cooperatives, and steelmaking equipment.

TEFRA SAFE HARBOR LEASING

1. A 50 percent limitation is imposed on the tax liability that a lessor may avoid through benefits purchased in safe harbor leases. Tax liability for this purpose is net of credits. However, it is also computed without regard to items which are properly allocable to qualified leased property.
2. Lessors are not permitted to carry back any purchased benefits to prior years. Excess benefits may be carried forward indefinitely, subject to the 50 percent limit in the year of carryover.
3. Lessors must depreciate property leased under safe harbor leases over the longer period used for minimum tax purposes (that is, five years for 3-year ACRS property, eight years for 5-year ACRS property). The method of depreciation is 150 percent declining balance, with a half-year convention and a switch to straight-line at the optimum point.
4. Investment tax credit on leased property must be amortized over five years, one-fifth per year. The new basis reduction of one-half of the credit, takes effect in full, however, the first year. It should be noted, that the lessor has a choice whether to reduce basis by half the credit or to reduce the amount of the credit (see investment credit section of this booklet). While the decision whether to reduce the depreciable asset basis or to reduce investment credit will depend on the facts of the particular situation, it will probably be more advantageous to reduce the amount of the credit, as long as the investment credit has to be spread over five years.
5. The lessee must compute his taxable income limitations on percentage depletion deductions as if he owned the leased prop-

erty. Therefore, for percentage depletion purposes the lessee must take into account depreciation deductions and disregard rentals and interest associated with the safe harbor lease.

6. The lessee-user will only be allowed to lease up to 45 percent of "qualified base property" placed in service in any calendar year. Qualified base property generally means property that is eligible for the investment credit. The base property to which the percentage limitation applies generally consists of: (1) new investment credit property of the taxpayer, and (2) certain leased property (which is also new investment credit property) with respect to which the taxpayer is lessee.

7. The maximum allowable interest rate for deduction purposes on obligations of the lessor to the lessee equals the statutory interest rate on underpayments of tax, 20 percent for 1982; the rate for 1983 will most likely be lower.

8. The maximum lease term is the recovery period applicable to the property or, if greater, 120 percent of the present class life of the property.

9. Safe harbor leasing between related corporations is generally prohibited.

10. Safe harbor leasing is not available for public utility property.

11. Certain tax-exempt entities are not allowed to structure deals to take advantage of safe harbor leasing. This rule does not apply to property used by a tax-exempt organization in an unrelated trade or business or to farmers' cooperatives whether or not they are tax-exempt.

12. The at-risk rules are amended to allow closely held corporations (but not personal holding companies or Subchapter S corporations) to be safe harbor lessors. However, the at-risk rules still apply to lessees. Therefore, the lessor will be considered to be at-risk up to the amount that the lessee is at-risk. This change does not apply to closely held lessors that are personal service corporations.

13. Safe harbor leases that "sell" only the investment credit without depreciation deductions are specifically allowed if entered into before October 20, 1981. This is the so-called "ITC strip" lease. No specific statutory provision affects ITC strip leases entered into *after* October 19, 1982. The official Treasury position is that it has reserved the right to deal with these transactions in future regulations. While there is no decision yet on the status of ITC strip leases entered into after October 19, 1982, we question whether they will be allowed.

14. Safe harbor leasing is completely repealed as of January 1, 1984.

15. The changes to safe harbor leasing are generally effective for agreements entered into, or property placed in service after July 1, 1982 (except for "grandfathered" property under the transition rules, see above). However, the rules relating to transactions between related parties and to percentage depletion are effective for leases entered into after February 19, 1982.

FINANCE LEASING

"Finance" leasing is a new tax concept contained in TEFRA, and is not to be confused with finance leasing under FASB pronouncements. The finance lease rules enacted by TEFRA liberalize guidelines on leasing issued by the IRS in 1975, which require certain tests to be met for a transaction to qualify as a lease for federal income tax purposes.

In brief, the 1975 IRS guidelines are:

1. The lessor must have a 20 percent minimum unconditional at-risk investment.
2. The lessee may have no investment in the property.
3. The lessee may not lend any of the purchase price to the lessor or guarantee any lessor loan.
4. All purchase options must be at fair market value on exercise date, and the lessor cannot "put" the property to the lessee.
5. The lessor must, exclusive of tax benefits, receive a profit, as well as a positive cash flow from the transaction.
6. Property that can only be used by the lessee is not eligible for lease.

These rules are still important because transactions meeting their standards are not subject to any of the restrictions enacted in TEFRA on either safe harbor or finance leases.

Essentially, TEFRA finance leases relax the above guidelines in three areas. First, a fixed-price purchase option of at least 10 percent of original cost would be allowed. Second, property that can be used only by the lessee is eligible for lease and, third, a 3-month period (also referred to as the "90-day window") after the placed-in-service date is allowed when arranging lease transactions. Certain restrictions, however, apply to finance leasing:

1. Eligible property includes new property that qualifies for the investment credit, except for (1) public utility property, (2) property for which rehabilitation tax credits are claimed, (3) property used by certain former tax-exempt organizations, and (4) property

used by a foreign person (the income from which is not subject to U.S. tax).

2. A lessee may lease only 40 percent of otherwise eligible property (this restriction sunsets after calendar 1985).

3. The lessor may avoid only 50 percent of its tax liability through finance lease transactions (this restriction ends on September 30, 1985). Also, lessors are not allowed to carry back excess benefits to prior years.

4. The lessor must spread investment tax credit over five years as in safe harbor leases (this restriction also ends on September 30, 1985).

5. As with safe harbor leasing, the lessor must be a corporation other than a Subchapter S corporation or personal holding company. Also, finance leases between related parties are not allowed.

The finance lease rules are generally effective on January 1, 1984, the same time that safe harbor leasing ends. However, leases of new farm equipment entered into after July 1, 1982, that aggregate $150,000 per year may qualify for finance lease treatment without the restrictions described in (2), (3), and (4) above.

Planning Considerations

Please note that leases using the existing 1975 IRS lease guidelines rather than the finance lease rules will not be subject to the restrictions described above. Also, after January 1, 1984, use of the 3-month period to arrange transactions will not cause the lease agreement to be subject to the finance lease restrictions. Leases involving either the 10 percent purchase option or property usable only by the lessee *will* subject the lease to the restrictions. The restrictions other than on eligible property will not affect leases entered into after September 30, 1985, (or calendar year 1985 in the case of the 40 percent lessee restriction). Another TEFRA provision prevents the IRS from retroactively denying lease treatment under the pre-ERTA lease rules to motor vehicle leases containing terminal rental adjustment clauses.

Finance leasing after 1983, has only two advantages over true leases under the 1975 IRS ruling guidelines: Namely, the ability to lease property usable only by the lessee, and the ability to have a fixed purchase option of not less than 10 percent of the property's original cost. However, the effect of the restrictions on finance leasing (until they expire on September 30, 1985, and January

1, 1986) will probably cause this technique to be little utilized except for property that can be leased in no other way, such as property usable only by the lessee. It does not appear that the ability to have a 10 percent purchase option will make up for the fact that a lessor must spread investment credit over five years.

The changes described above will obviously have an adverse effect on the economics of safe harbor leasing. It is equally clear, however, that leasing, in some form, as a financing tool, is still with us, and probably will continue to be. The major impact of the current changes is to lessen substantially the price lessors will pay for tax benefits in nontraditional leases.

From the lessee's point of view, not only will he receive less for tax benefits sold in safe harbor leases, but there is also a significant limitation on property that can be leased. The new 45 percent and 40 percent limitation on property eligible for safe harbor or finance leases will especially cause difficulty when the lessee will place in service only one major asset during the year. Where safe harbor or finance leasing is desired, it may well be necessary to sell an undivided interest of 45 percent or 40 percent, respectively, in the property. It may also be possible to sell an undivided interest in each piece of eligible property as it is placed in service throughout the year. This can be important because if an entire large asset is safe harbor leased early in the year, it may be retroactively disqualified if the lessee does not place enough additional eligible property in service for the remainder of the year.

The lessee cap of 45 percent or 40 percent of property eligible for lease is crucial. Failure to meet this test will result in disqualification of the property for safe harbor or finance lease treatment. Note that the property leased last during the calendar year is the first property denied lease treatment under the lessee cap. If the lessee leases only one major asset which turns out to exceed the limitation, it is unclear whether the entire transaction will be disqualified or only that portion exceeding the lessee cap.

Another planning opportunity arises when the lessee determines, late in the calendar year, that the 45 percent or 40 percent cap may not be met; the lessee can purchase or lease additional property sufficient to cause the test to be met. Some manipulation of the lessee cap should therefore be possible through careful timing of other purchases or long-term leases of new investment credit property.

An important consideration for lessees and lessors is the transition rule that will allow some grandfathered safe harbor leasing without the TEFRA restrictions. Potential lessees should quickly determine which investment credit property was acquired, when construction was begun, or what agreements to purchase under binding contract were made between January 1, 1981 and July 1, 1982. If this property will be placed in service before 1983, it may be safe harbor leased without the TEFRA restrictions. Because lessors will not have to spread depreciation and investment credit on this grandfathered property, the lessee will receive a significantly higher price for the tax benefits. Also with respect to grandfathered property, the lessor will be able to use currently purchased credits in excess of 50 percent of its tax liability and carry the excess back to previous years. Grandfathered property under the transition rule is, in effect, a privileged class of property, and serious consideration by both lessees and lessors should be given to safe harbor leasing as much grandfathered property as possible before January 1, 1983. However, grandfathered property does count toward the computation of the cap on the amount of property a lessee can lease in 1982 and 1983.

For a lessor, it is now crucial to estimate accurately tax liability for the year before purchasing tax benefits in a safe harbor or finance lease. Obviously, the price the lessor pays for tax benefits depends on the value of the tax deferral to be realized from their purchase. If the lessor purchases benefits equal to more than 50 percent of its tax liability, the excess will be delayed to future years, thus significantly lowering their value.

Due to the effect of the "90-day window" (property must be leased within three months of its placed-in-service date), the 45 percent or 40 percent limit on the lessee, described above, and the 50 percent limitation on the lessor's purchased benefits, we may anticipate more major transactions being delayed until late in the lessor's taxable year so as to minimize risks associated with failure to meet these tests. Also, from a competitive point of view, one possible result of these changes could be more leasing companies having tax years other than the calendar year so their year-ends will come during the course of a lessee's fiscal year, thus enabling them to compete more freely for leases while lessees are seeking to place property.

As a result of these new rules and restrictions, it is obvious that old-style "true" leases are still alive and well. In many situations, they may now be more desirable compared to safe harbor leases or finance leases, especially since the lessor in a true lease will not have to delay utilizing investment credits and depreciation. However, the restrictive IRS rules (described above) associated with true leases will continue to limit feasible transactions. Generally, true leases will have their greatest utility for property expected to have substantial residual value at the end of the lease term.

Table 5-1 compares safe harbor leasing, as amended by TEFRA, against old-style true leasing, finance leasing, and safe harbor leases before the TEFRA changes.

All the transactions briefly described in Table 5-1 are available either as direct leases from lessor to lessee or as a sale and leaseback. Both of these forms of leasing offer advantages. In direct leases, the lessor purchases the property from a party other than the lessee. Therefore, the lessee need not make any downpayment or incur any debt (at least for tax accounting purposes). The lessee's benefits in a direct lease are passed through in the form of reduced rental payments. A sale and leaseback requires less advance planning than a direct lease in that the lessee can purchase the property and then sell it to the lessor. This eliminates potential problems relating to whether the property is suitable for the lessee's needs. The choice of whether a direct lease or a sale and leaseback is used in any particular situation will depend on the needs of the parties.

This discussion is by no means exhaustive. It is intended both to highlight the differences and illustrate the flexibility of leasing transactions. Many different ways to lease an asset are possible, and each will involve different terms and economic assumptions. It should be possible to tailor a leasing transaction to fit almost any need—but the economics may well change for many such leases.

Table 5-1. Leasing Methods Compared

	Safe Harbor Lease Before TEFRA Changes	*Safe Harbor Lease as Amended by TEFRA (Sunsets on 12/31/83)*	*Finance Lease (Available After 12/31/83)*	*True Leveraged Lease Under 1975 IRS Guidelines*
Original lessor at-risk investment	10% minimum	10% minimum	20% minimum	20% minimum
Lease term	Minimum: ACRS life Maximum: 150% of ADR life, or if greater, 90% of useful life	Minimum: ACRS life Maximum: 120% of ADR life, or if greater, the depreciation period	No minimum Maximum: 80% of useful life	No minimum Maximum: 80% of useful life
Purchase option by lessee	Can be nominal	Can be nominal	10% minimum	Fair market value when exercised
Put to lessee	Yes	Yes	No	No
Residual value at end of lease term	None necessary	None necessary	Minimum 10% of original basis	20% of original basis
ITC period	Full credit in first year	5 years, 1/5 per year	5 years, 1/5 per year (until 9/30/85)	Full credit in first year

Table 5-1. Leasing Methods Compared (continued)

	Safe Harbor Lease Before TEFRA Changes	*Safe Harbor Lease as Amended by TEFRA (Sunsets on 12/31/83)*	*Finance Lease (Available After 12/31/83)*	*True Leveraged Lease Under 1975 IRS Guidelines*
Depreciation period	ACRS table	Minimum tax period—150% DB	ACRS table	ACRS table
Usable by party other than the lessee	Not necessary	Not necessary	Not necessary	Required
Positive cash flow to lessor	Not necessary	Not necessary	Required	Required
Legal title to property	Either party	Either party	Lessor	Lessor
Rentals	Usually an amount necessary to amortize purchase price plus interest—discounted for tax benefits	Usually an amount necessary to amortize purchase price plus interest—discounted for tax benefits	Fair market value	Fair market value
All rent deductible by lessee	Yes	Yes	Yes	Yes

90-day window	Yes	Yes	Yes	No for transactions through 12/31/83; then yes
Lessee loans or guarantees	Yes	Yes	No	No
Other factors	a. Not applicable	a. Lessor must defer use of purchased benefits in excess of 50% of tax liability. (Computed without regard to safe harbor lease items.)	a. Lessor must defer use of purchased benefits in excess of 50% of tax liability (until 9/30/85)	a. Not applicable
	b. Not applicable	b. Lessee may not lease more than 45% of all new investment credit property (including certain leased property) placed in service during the year.	b. Lessee may not lease more than 40% of eligible property (through calendar 1985)	b. Not applicable

6
Life Insurance Tax Provisions

Points to Consider

- **The Act makes the most sweeping changes in the taxation of the life insurance industry and its products since 1959.**
- **Annuity holders and some policyholders will find themselves adversely affected by the new law, and should consult their tax advisers and insurance agents to avoid or minimize economic loss.**
- **Life insurance companies must pay careful attention to their 1982 estimated-tax situations before December 15. Some may find themselves entitled to "quick refunds" early in 1983.**

The new provisions of the Act fall into three general areas:

- Permanent changes in the computation of taxable income for life insurance companies
- Temporary "stop gap" provisions, which give life insurance companies relief while Congress studies industry issues and formulates additional permanent modifications
- Provisions directed toward penalizing those individuals who utilize tax-favored life, annuity or endowment insurance contracts primarily as short-term investment vehicles or tax-savings devices

The primary effect on individuals is the loss of some flexibility in being able to invest in tax-favored insurance products. These provisions require a number of timely decisions from life insurance company executives, which will indirectly affect the majority of life insurance policyholders.

Individuals

In recent years, numerous insurance products (such as single premium deferred annuities and universal life) have been designed to take advantage of tax-deferred treatment for what, in many cases, are short-term investments. The Act effectively penalizes individuals who invest in these "abusive" products by modifying the computation of taxable income for amounts received from life, annuity and endowment contracts, and by providing that death benefits will not be excluded from taxable income for certain life insurance products.

Under new provisions, amounts received before the maturity of an annuity will generally be taxed on the last-in-first-out basis rather than on a first-in-first-out basis. Consequently, some payments which previously were considered nontaxable return of investment will now be taxable. The new measure to be used in determining the amount of taxable income is the excess of the policy's cash value over the investment in the policy. Pledging, assigning of, or borrowing against an annuity policy's cash value will be considered a withdrawal subject to these new provisions. Treasury is also given the authority to issue regulations prescribing situations in which the new provisions will apply to life insurance and endowment policies. These rules apply to new policies or to new investments in existing policies after August 13, 1982.

Additionally, amounts which are considered taxable income may be subject to a 5 percent penalty tax, which will apply to "premature withdrawals"; that is, generally, to those made after 1982, within 10 years of investment.

The penalty provisions will not apply to distributions:

- To taxpayers aged 59½ or over;
- That are attributable to a policyholder's disablement; or
- To a beneficiary on or after the annuitant's death.

Or to payments:

- Under an annuity for life of the taxpayer or over a period of not less than five years;
- From a contract under a qualified plan; or
- To those allocated to investments before August 14, 1982.

Death benefits received under flexible premium life insurance products (for example, universal life) will be taxable under the new provisions unless the products satisfy one of two tests. The first is two-pronged, whereby:

- Premiums charged under the policy may not exceed a "guideline premium" amount, and
- The death benefit in the contract must not be less than a specified "applicable percentage" of the policy's cash value. The applicable percentage used is based on the age of the insured.

The second (alternative) test is that the policy's death benefit may not at any time exceed a defined "net single premium" amount. The premium tests are based on specific actuarial factors. This provision will be effective for death benefits paid after 1982, under contracts entered into before 1984. A transitional rule of up to one year after the enactment date, applies to contracts entered into before 1983.

Individual holders of the newer life insurance industry products will wish to review with their tax advisers and their life insurance agents the status of those contracts under the Act. New (or existing) annuities, life, or endowment policies may have potential taxability. New insurance products or alternative investments may have to be considered for investors to be assured of equivalent after-tax returns comparable to those they had anticipated before TEFRA.

Life Insurance Companies

The Act changes numerous items in the life insurance company taxable-income formula. This unique formula, which originated in 1959, has been affected in recent years by high interest rates. Consequently, the industry's tax burden during most of the 1970s grew at a much faster rate than other industry factors. In the last several years, taxes paid by the industry decreased dramatically because many companies utilized certain tax-favored arrangements (modified coinsurance, or "Modco") to lower their taxes significantly.

Provisions in the Act repeal the tax advantages of Modco contracts while providing some relief for inflation-produced industry problems. The "relief" provisions are effective for a two-year "stop gap" period during which Congress intends to study the industry's unique circumstances and to make permanent changes to the taxable income formula that will be equitable to both the industry and the government.

In addition to repealing the favorable treatment of Modco contracts, the Act contains the following permanent provisions:

- It lowers the "net level revaluation" factor used by some companies to compute tax reserves for ordinary business (applicable to new contracts entered into after March 31, 1982).
- It blocks the use of any coinsurance contract to transfer interest amounts (the key to Modco tax benefits) and policyholder dividend amounts.
- It allows companies to deduct certain interest amounts ("qualified guaranteed excess interest") paid to policyholders. Treatment of these amounts, which exceed contractual rates and are guaranteed in advance, has been a major point of contention between insurers and the IRS.

The Act's "stop gap" section, effective through 1983, has the following temporary provisions:

- It increases the limitation on the deductions for dividends paid to policyholders and "special deductions" related to certain business, but reduces or eliminates the statutory amount for large insurers.
- It establishes the treatment, in computing tax reserves, of interest amounts guaranteed in excess of contract rates.
- It modifies, in light of the current inflationary economy, the "Menge" formula applied to ordinary life reserves in the tax computation.
- It provides for a "bottom line" consolidation method for groups of life companies that file consolidated returns.
- It prohibits the disqualification of life insurance companies' status because of the lack of permanent purchase-rate guarantees on annuity products.

These stop gap measures, while providing short-term relief to many companies, do not provide them with adequate information to make long-range decisions (for example, product pricing) which incorporate tax costs.

Perhaps the most important action step a life insurance company should take, aside from projecting what these new rules will mean to its entire business, is a rapid and detailed projection of estimated taxes for 1982. Unlike several other sections of TEFRA, where provisions are effective before 1983, there is no "saving" section applicable to life insurance companies that prevents them from being assessed a penalty for underpayment of estimated taxes. The new law will apply to a December 15, 1982 underpayment.

Some life insurance companies will find the effect of the new law to be a *decrease* in 1982 tax liability. For them, there will be an opportunity to recover overpayments of 1982 tax already remitted to the government by adjusting their remaining estimated tax installments for 1982. The "quick refund" provision is available to those companies that remain overpaid at year end.

7

Retirement Plans

Points to Consider

- Qualified corporate plans will have to be amended to comply with new limitations.
- Consideration should be given to amending noncorporate plans to take advantage of new, less restrictive rules applicable to such plans.
- Incorporation for sole proprietors and self-employed individuals may no longer be as attractive.
- Consideration should be given to changes in contribution formulas and/or benefit structures for plans which may otherwise be classified as "top-heavy" plans and therefore subject to additional restrictions.
- Group-term life insurance programs should be reviewed to determine whether coverage is sufficient to avoid classification of the plan as discriminatory.
- Outstanding loans by retirement plans to participants should be reviewed to determine whether partial repayment is required on or before April 13, 1983, to avoid distribution treatment.
- Closely held personal-service corporations come even more under attack, and may wish to consider liquidation before 1985.

Notwithstanding the enactment in 1974 of the Employee Retirement Income Security Act (ERISA) and the numerous changes that were made to it before the passage of TEFRA, there was continuing concern on the part of many individuals that the rules allowed abuses with respect to highly paid individuals. Additionally, the discrepancy in the treatment of tax-sheltered retirement contributions for self-employed individuals and corporate employees was widely regarded as being unjustified. Many of the provisions of TEFRA dealing with pensions are intended to remedy these situations.

Major Impact

Specifically, the Act includes the following measures, which are designed to achieve parity between qualified plan rules for corporate and noncorporate employers:

- The limitation on contributions to defined contribution plans (that is, profit-sharing, stock-bonus and money-purchase pension plans) is to be reduced from a current level of $45,475 to $30,000 per year.
- The limitation on benefits for defined benefit pension plans is to be reduced from a current level of $136,425 to $90,000 per year.
- For HR 10 (Keogh) plan years beginning after 1983, the maximum tax-deferred contribution for self-employed individuals is increased from $15,000 to $30,000 a year. The special plan rules which prevent certain Keogh plans from limiting coverage to a fair cross section of employees and prohibit integration with Social Security are also repealed.

The foregoing provisions, with the exception of the Keogh provision, are effective for plan years beginning after 1982 for plans which were in existence on July 1, 1982. Plans which were not in existence on July 1, 1982 must conform from inception.

In addition, effective for years beginning after 1983, certain special rules previously applicable to Keogh plans are extended by TEFRA, with some modifications, to plans of corporate and noncorporate employers which primarily benefit key employees (top-heavy plans). These changes include rules relating to (1) includible compensation, (2) vesting (alternative schedules are provided), and (3) distributions. The new rules for top-heavy plans also require that such plans provide nonkey employees a nonintegrated minimum benefit or a nonintegrated minimum contribution, and, in some cases, reduce the aggregate limits on contributions and benefits for key employees who are covered by more than one plan of an employer.

As a result of these changes, qualified corporate retirement plans will have to be amended to comply with the new limitations. However, the Act specifically provides that a plan shall not be treated as failing to meet the new requirements for any year beginning before January 1, 1984 merely because the plan provides for benefit or contribution limits which exceed the new limitations (that is, so long as the new limitations are in fact complied with).

Decisions to Make

Partnerships and self-employed individuals considering incorporation must now take into account the fact that retirement plan restrictions will be essentially identical regardless of whether or not they incorporate. Amending existing noncorporate plans may be desirable in any event to take advantage of the relaxed rules now applicable to such plans.

Corporate employers considering adopting plans that would primarily benefit the major shareholders will have to weigh the impact of the new top-heavy plan rules before proceeding. Moreover, sponsors of existing top-heavy plans will have to decide whether to make the minimum changes required to comply with the Act or whether to make larger scale changes affecting their fundamental design. In some cases, the alternative chosen may even be termination of a plan.

On the other hand, sponsors of corporate plans which are not top-heavy will have to determine whether and how to replace benefits denied to the highest-paid employees due to the reduced limitations. Corporations that currently sponsor only one type of plan (for example, either a defined-contribution or a defined-benefit plan) may wish to add an additional plan of the other type to reach the new 1.25 combined limitation (discussed below). As an alternative, an increase in nonqualified deferred compensation for individuals may be considered.

Additional Changes

Other important changes in the pension rules made by TEFRA include:

- Effective for plan years of existing plans beginning after 1982, the earliest retirement age for unreduced maximum defined benefits is increased from 55 to 62.

- Benefit distributions for plan years beginning after 1983 must start by age 70½ or, in the case of an employee other than a key employee-participant in a top-heavy plan, the year in which he or she retires, whichever is later. Additionally, death benefits, except for spousal annuities and period-certain annuities, must be paid out within five years.

- Effective for plan years beginning after 1983, defined-contribution plans may no longer integrate with Social Security by allowing contributions of 7 percent of compensation over the wage base. The new limit is the Old Age Survivors and Disability Insurance (OASDI) rate under Social Security (scheduled to be 5.4 percent through 1984, and 5.7 percent for 1985 through 1989). For example, if the provisions were applicable for 1982, a profit-sharing plan could provide contributions at 5.4 percent of 1982 pay in excess of $32,400 and none below that level.

- New or renewal loans to participants after August 13, 1982 must be restricted to $10,000 or, if greater, 50 percent of the value of the vested benefit up to $50,000. Loans must be paid off within five years, except loans for acquiring, constructing, or substantially rehabilitating a building used as a principal residence by the participant or a family member. Loans not meeting these requirements are treated as distributions.

A special transition rule provides that loans which are outstanding on August 13, 1982, and which are renegotiated, extended, revised or renewed after that date will not be treated as made on the date of renegotiation, etc., to the extent such amounts are required to be, and are in fact, repaid on or before August 13, 1983.

Plans must be amended to reflect the new retirement age and distribution provisions.

Limitations

DEFINED-CONTRIBUTION PLANS

As stated above, maximum annual contributions to defined-contribution plans, for years of existing plans beginning after 1982, are reduced by the Act from a current level of $45,475 to $30,000. The limitation is frozen at this level until years beginning on or after January 1, 1986, when cost-of-living adjustments using a 1984 base period will resume. Annual additions include: (1) employer contributions; (2) forfeitures; and (3) the lesser of (a) employee contributions in excess of 6 percent; or (b) 50 percent of employee contributions. No grandfather provision is provided with respect to the new limitations. Designers of plans in which forfeitures may play a significant role will have to be extremely cautious in gauging the impact of the new lower limitation.

DEFINED-BENEFIT PLANS

As noted, the maximum dollar limitation, for years of existing plans beginning after 1982, is reduced from $136,425 to $90,000. As in the case of defined-contribution plans, no cost-of-living adjustments will be allowed until years beginning on or after January 1, 1986. The impact on a sole shareholder of a closely held corporation who is currently 45 years old and planning to retire at age 55, who otherwise would have been entitled to a lifetime retirement benefit of $136,425 under pre-TEFRA limitations, would be to reduce annual tax-deductible contributions from $133,264 to $87,915. This change reflects funding for the reduced limitation of $90,000 (based on level funding assuming a 5 percent yield and post-retirement mortality in accordance with the 1971 Group Annuity Mortality Table).

In addition, the earliest retirement age at which the maximum $90,000 benefit can be provided is increased from age 55 to age 62. The sole shareholder in the example above must either delay retirement to age 62 or fund for a benefit of less then $90,000 starting at age 55.

The new rules strictly prohibit advance recognition of future cost-of-living funding adjustments and also prohibit any interest assumptions of less than 5 percent for making any necessary actuarial adjustments.

COMBINATION OF PLANS

The Act reduces the cumulative limitations applicable to the maximum *dollar* limitations from 1.4 to 1.25 but retains the 1.4 *percentage* limitation. The new limitation is illustrated by the following two examples:

1. Maximum dollar limit: Individual A is entitled to an annual defined-benefit of $90,000 for life at age 62. His maximum defined-contribution annual addition is therefore calculated as $(1.25 - 1.0) \times \$30,000 = \$7,500$.

2. Maximum percentage limit: Individual A is entitled to an annual defined benefit of 100 percent of his final three-year average pay, or $50,000 for life at age 62. His maximum defined contribution annual limitation is calculated as $(1.4 - 1.0) \times .25 = 10\%$.

It should also be noted that a grandfather provision will permit plans currently exceeding these cumulative limitations to continue at such levels provided there are either no future annual additions to the defined contribution plan or no additional accruals under the defined benefit plan for affected participants.

The effective dates referred to previously may be different for collectively bargained plans.

Additional Changes Affecting Keogh and Subchapter S Plans

Other significant changes made by TEFRA for plan years beginning after 1983 are:

- The complicated qualification rules applicable to defined-benefit Keogh plans are repealed. As a result, compensation in excess of $100,000 may now be recognized in determining benefits and defined-benefit plans which cover self-employed individuals or Subchapter S corporation shareholder-employees will be subject to the same rules applicable to other defined-benefit plans.
- Contributions on behalf of owner-employees in excess of the deduction limit may now be made and the 6 percent excise tax on excess contributions on behalf of owner-employees is repealed.
- The plan trustee no longer needs to be a bank or another approved financial institution.
- The plan need not cover all employees with three years of service but, instead, may meet the "reasonable cross-section" test.
- Unless the plan is top-heavy, it can make distributions to nondisabled owner-employees before age 59½.
- The plan may use six-year vesting (20 percent after two years, plus 20 percent for each additional year) instead of immediate vesting after three years or, if it is not top-heavy, any appropriate ERISA vesting schedule.
- The $5,000 income exclusion for death benefits is now available with respect to the payment of such benefits to self-employed individuals.

Partial IRA Rollovers

Under the rules in existence before TEFRA, distributions from an IRA were eligible for tax-free rollover treatment only if the entire amount of the distribution was rolled over to another eligible retirement plan, while distributions from other types of qualified plans were eligible for tax-free rollover treatment to the extent of any amount so transferred. Effective for distributions made after 1982, the Act provides that an IRA distribution may be partially rolled over to another eligible retirement plan.

Group-Term Life Insurance

Effective for years beginning after 1983, the income exclusion for the first $50,000 of employer-provided group-term life insurance is not available to a key employee if the plan discriminates as to participation or benefits. If the plan is discriminatory, key employees will be taxed at the uniform table rates on the total amount of group-term insurance provided for them.

The definition of a key employee is the same as that used with respect to the new top-heavy plan rules and includes employees who (1) are officers (using the facts and circumstances test), (2) are one of the ten employees owning the largest interest in the employer, (3) own more than a 5 percent interest in the employer, or (4) earn more than $150,000 per year and own more than a 1 percent interest in the employer.

Top-Heavy Plans

Under TEFRA, additional qualification requirements, effective for years beginning after 1983, have been established for plans which primarily benefit an employer's key employees (top-heavy plans). The Act also includes rules under which two or more plans of a single employer are aggregated to determine whether the plans, as a group, are top-heavy.

A defined-benefit plan is a top-heavy plan for a plan year if the present value of the accumulated accrued benefits for "key employees" (as defined above in the discussion relating to group-term life insurance) exceeds 60 percent of the total present value of accumulated benefits. A defined-contribution plan is top-heavy if for a plan year the sum of the account balances of participants who are key employees for the year exceeds 60 percent of the sum of the account balances of all employees under the plan.

The following special rules apply to top-heavy plans:

1. Only the first $200,000 of an employee's compensation may be taken into account in determining contributions or benefits under the plan.

2. Plans must choose one of two vesting schedules; either 100 percent after three years or a 6-year vesting schedule with 20 percent after two years and increasing 20 percent per year.

3. Minimum benefits and contributions for nonkey employees:

- Under a defined-benefit plan, the minimum benefit for nonkey employees must be 2 percent of the high 5-year average annual compensation times the number of years of service while the plan is top-heavy, but not in excess of 20 percent of the 5-year average compensation.
- For a top-heavy defined contribution plan, the minimum contribution for nonkey employees is 3 percent of the participant's compensation in each year unless contributions for each key employee are less than 3 percent. In the latter case, the required minimum contribution rate for each nonkey employee generally is limited to not more than the highest contribution rate for any key employee.
- The minimum benefits for nonkey employees may not take Social Security into account.

4. There is a 10 percent excise tax on distributions to key employees before age 59½ unless made on account of death or disability. Also, benefit distributions must start at age 70½ even if the key employee is still employed.

5. Further limitations apply where plans fail a so-called concentration test (which means that more than 90 percent, as opposed to 60 percent, of the benefits or account balances are attributable to key employees). In this case, key employees are limited by a 1.0 rule on combinations of plans, as opposed to the 1.25 rule for dollar amounts for other corporate plans. This rule also applies to a plan which meets the concentration test, but which does not provide an extra minimum benefit or contribution for nonkey employees. The required extra minimum benefit is the lesser of (1) 1 percent of the high 5-year annual compensation times the number of years of service, or (2) 10 percent of such average compensation. In the case of a defined-contribution plan,

the required extra minimum contribution is 1 percent of the compensation for the year.

Obviously, sole shareholders and many self-employed individuals will not only find themselves in top-heavy plans but will also be unable to meet the concentration test. Accordingly, such individuals will be subject to the 1.0 limitation applicable to combinations of plans.

Organizations Performing Management Functions

Effective for taxable years beginning after 1983, the Act expands the class of employers to be treated as a single employer for purposes of applying certain tax rules (including the rules for top-heavy plans), to qualified plans, cafeteria plans, medical reimbursement plans and simplified employee pensions (SEPs). The new provision states that if an organization's principal business is performing, on a regular and continuing basis, management functions for one organization (or for one organization and other organizations related to such organization) the person performing the functions and the organization or organizations for which the functions are performed are to be treated as a single employer. For purposes of the provision, the term organization includes an individual, corporation, partnership, etc.

Employee Leasing

The new Act also provides that for employee benefit plan purposes, an individual (a "leased" employee) who performs services for another person (the recipient) may be treated as the recipient's employee where the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) that is otherwise treated as the individual's employer. Under the provision, which is effective for taxable years beginning after 1983, the individual is to be treated as the recipient's employee only if he has performed services for the recipient (and related persons) substantially full-time for a period of at least 12 months. Additionally, the services must be of a type historically performed by employees in the recipient's business field.

The employee leasing rules do not apply when services in a particular business field have historically been performed by one person for another.

Contributions or benefits for the leased employee which are provided by the leasing organization under its qualified plan or SEP are to be treated as if provided by the recipient, to the extent such contributions or benefits are attributable to services performed by the leased employee for the recipient.

However, an individual who otherwise would be treated as the recipient's employee will not be treated as such if certain requirements are met with respect to contributions and benefits provided for the individual under a qualified money-purchase pension plan maintained by the leasing organization. In order to be qualified, such a plan must provide that amounts are to be contributed by the employer on behalf of the employee at a rate not less than 7½ percent of the employee's compensation for the year and such compensation must not be reduced by integration with Social Security.

Limitation on Estate Tax Exclusion for Retirement Plan Distributions

Under TEFRA, the aggregate amount of an annuity received from a qualified plan or an IRA that may be excluded from the gross estate of a decedent may not exceed $100,000. This provision applies to estates of decedents dying after December 31, 1982.

Personal Service Corporations

The conferees considering TEFRA have included in the law one provision whose legislative parentage is—at best—dubious, but which will be perceived by some as dealing a finishing blow to many one-man professional corporations—personal service corporations, as the statute calls them. The new rule, discussed below, is stated as being of dubious legislative parentage because it was not in the Senate Finance Committee version of the Act, nor was it added on the floor of the Senate when that body voted to approve its version of the Act; it was not included in the original House bill, parts of which formed the basis for the pension provisions of the new law; there were never any hearings on the provision on either the House or the Senate side—it just seemed to wander into the final conference bill with absolutely no publicity, debate, or other legislative history. Its effect may be more psychological than real for the class of professional corporations affected, but we expect the new section to gain some popularity with examining revenue agents.

For years beginning after 1982, a corporation whose principal activity is the performance of personal services *may* have a pro rata share of its income, deductions, or other tax benefits allocated by IRS to any shareholder owning more than 10 percent of its stock, if substantially all services are performed for only *one* other entity. Thus, the provision would not apply, presumably, to a professional corporation (PC) of various lawyers providing services to a wide variety of clients; it would apply to a one-lawyer PC that provides exclusive services to a law firm partnership, whether or not as a partner.

The controlling word with respect to the allocation is that IRS *may* allocate: it will not be required, for example, that the Service allocate net operating losses out of the corporation to its shareholders. The 10 percent ownership rule includes very strict attribution rules; that is, husband and wife are considered as owning each other's shares, lineal ascendents and descendents will have their shares attributed to the intervening generations, etc.

De facto disregard of the corporate entity, vis-a-vis reporting of corporate income, is only permitted if "the principal purpose" of forming or using the corporation is to obtain any type of tax benefit *that might otherwise not be available;* the most significant is corporate versus self-employed retirement plans. As discussed on page 96, "principal purpose" does not mean 51 percent of the reasons for setting up the corporation; a plurality of purpose is sufficient.

The net effect of this provision is likely to be a broader attack on some professional corporations by IRS, particularly where the professional is the only employee. And the attack may arise more from an awareness of this "tool" by an examining agent than by a particularly real need for the provision. For example, the most universal primary advantage of the professional corporation is the availability of corporate retirement plans. Yet, in 1984 the rules for corporate and self-employed plans will be the same, and it will certainly not be possible for IRS to argue successfully that a PC was set up thereafter to obtain a retirement tax advantage "not otherwise available." This will leave IRS applying this new section to attack somewhat more ephemeral benefits such as medical reimbursement plans, group life insurance exclusions (for a one-man corporation?), etc.

Still, because of the new income allocation powers granted IRS, and since professional corporations will become substantially less attractive in any event due to the new parity rules for corporate and self-employed retirement plans, Congress is permitting most such corporations to completely liquidate, returning their assets to their shareholders, on a tax-favored basis. To qualify, there must be a complete liquidation of the corporation "during 1983 or 1984." Presumably, that will require completion of the liquidation by December 31, 1984, rather than adoption of a liquidating plan by that date. The vehicle selected for the liquidation must be the "one-month" liquidation presently provided by the Internal Revenue Code in a regular corporate context, whereby the corporation's unrealized receivables will not be taxed at the corporate level at the time of liquidation. It would not be surprising if many professional corporations chose to take advantage of these liquidation provisions within the next two years.

The tax-favored liquidation route is only available to those personal service corporations whose primary activities are in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. That may still leave a few questions. It is not clear, for example, if the professional athlete would be characterized as being in the performing arts field, health(?), or none of the above.

8 Compliance

Points to Consider

- There have been major changes in the area of taxpayer compliance. These include expanded requirements for withholding and the filing of information returns, additional penalties, and even additional possible disclosure requirements on tax returns. Although hardly a topic for stimulating after-dinner conversation, taxpayers should be aware of the changes to avoid the many increased fines and penalties.
- Gifts of cash or income property to family members whose past tax liability may have been under $600 will both split the gifts and possibly avoid new withholding rules. Choices for doing this include outright gifts or Clifford trusts.
- Recipients of pension or annuity income may elect not to have any withholding, if they anticipate no penalty for underpayment of taxes at the end of the year. If an underpayment becomes apparent, the election may be revoked.
- Net operating loss and ITC carryback claims, including those not yet filed for 1981, should now be filed as soon as possible after the end of the loss year. Regardless of when filed, no interest is payable on the refund if IRS processes the claim within 45 days of receipt.
- For a nonshelter "grey" tax position, a taxpayer will have to show "substantial authority" to avoid disclosing it on a return. Well-documented opinions by tax advisers can be important in satisfying the taxpayer that there is, in fact, substantial authority.

Withholding on Dividends and Interest

For the first time, our tax laws will require withholding of federal income tax on payments of dividends, patronage dividends from cooperatives, and interest to noncorporate taxpayers, at a rate of

10 percent. Withholding is not required for interest paid by state and local governments on tax-exempt obligations, or on any interest paid by individuals.

Interest subject to withholding includes original issue discount. But the amount of required withholding on account of the discount for any taxable year may not exceed cash and cash-equivalent payments includible in income for that year. For example, withholding on a Treasury bill is required only for the year the bill matures.

Any individual whose income tax liability for the preceding year was less than $600 will be exempt from withholding. Thus, gifts to children under the Uniform Gifts to Minors Act, in Clifford trusts, etc., can—most importantly—shift the income to taxpayers in lower brackets, but they may also avoid withholding.

For an individual over 65, withholding will apply only if gross income approximates at least $13,300. If a couple files a joint return and either spouse is over 65, withholding is not required unless gross income is over $21,200. Low-income taxpayers under 65 are exempt if their gross income is less than $7,500 for an individual or $12,400 on a joint return. The above numbers are based on the 1983 tax rate tables; as rates decrease for calendar 1984, the minimum income figures will rise correspondingly.

Also specifically exempted from the new withholding requirements are payments to corporations, governments, security dealers, money market funds, exempt organizations, custodians and nominees, and others that collect payments on behalf of the payee. An exempt recipient must give an exemption certificate to a withholding agent to prevent withholding. However, intermediaries, such as money market funds, stockbrokers, bank custodians, or trustees that collect dividends and interest on behalf of their depositors, are required to act as withholding agents.

If a payor so elects, withholding is not required for any payment of interest that will not exceed $150 annually. Dividends do not come under this rule. Thus, some small savers may be expected to redistribute their savings accounts so that no more than $150 annual interest will be earned at any single bank or savings and loan association; and the "nuisance" of withholding could, therefore, be avoided (though the election not to withhold is the bank's, not the depositor's). At a 12 percent annual rate, a $1,000 deposit will produce less than $150 annual interest—even with continuous compounding. For a 5¼ percent passbook account rate, over $2,500 in deposits could still avoid withholding.

Generally, dividends for withholding purposes include any distributions out of earnings and profits, including property. A with-holder unable to determine the portion of a distribution that is a dividend must withhold on the full amount; however, withholding would not be required if the nondividend portion can reasonably be estimated. For withholding purposes, dividends do not include either amounts paid in redemption of stock which a shareholder may be required to treat as a dividend, or undistributed taxable income of a Subchapter S corporation. In addition, certain dividends from public utility stock that a taxpayer elects to reinvest are not subject to withholding.

Withholding is not required under the Act for any dividend or interest paid to a nonresident alien who is already subject to withholding under existing law or who is exempted from withholding by treaty.

The withholding provisions are scheduled to take effect July 1, 1983. Financial institutions, however, are permitted to defer withholding for interest paid on savings accounts, interest-bearing checking accounts, and similar accounts until December 31.

Caution. A corporation without accumulated or current earnings and profits at the time of a distribution should be alert to the possibility that earnings later in the taxable year may cause the distribution to be a dividend, thus creating a withholding liability. In such a case, the corporation should withhold on the gross distribution.

Speculation. With the federal government withholding tax on dividends and interest, can the states be far behind? Their administrative problems could be much more difficult than Uncle Sam's, however. As a general rule, nonresidents of a state are not taxable in that state on dividends or nonbusiness interest within the state. A Connecticut resident, for example, would not pay New York tax on interest income because he or she maintained a savings account in a New York bank. Likewise, neither Delaware nor California tax would be due from the same taxpayer receiving a dividend from a corporation incorporated in Delaware and headquartered in California. Thus, a large number of exemption certificates or tax returns claiming very small refunds would have to be processed by the withholding state.

Withholding on Pensions, Annuities, and Other Deferred Income

The new law also requires payors of pensions and annuities to withhold taxes, beginning January 1, 1983. (Prior law permitted tax to be withheld on annuity payments, but there was no requirement.) If the payment is an annuity or similar periodic payment, it is subject to the same withholding rules as wages, and a recipient can file a withholding exemption certificate with the payor indicating the number of exemptions to be taken into account. If a certificate is not filed, withholding is determined as if payment were made to a married individual claiming three withholding exemptions.

Having stated the above, however, the new law seems only to shift the emphasis on withholding, rather than truly instituting a new system. A recipient can avoid withholding by electing, for any reason, not to have withholding on periodic payments. The election will stay in effect until revoked.

For nonperiodic distributions, other than a lump-sum distribution of a recipient's entire balance, 10 percent withholding is required. Unlike periodic payments, the recipient may elect to avoid withholding on a distribution-by-distribution basis (as well as on an "until election revoked" basis). These withholding rules will apply, for example, to a partial surrender of an annuity contract and to distributions from IRAs.

In recognition of the difficulty some payors may encounter in instituting a withholding system, civil and criminal penalties for failure to withhold will not apply before July 1, 1983, if the payor made a good faith effort to withhold.

Strategy. Pension recipients and annuity holders, concerned about use of money by the government as opposed to themselves, may well want to take advantage of the "no withholding" election. Payors may also wish to encourage those elections to minimize costs of a new withholding system.

Action Step. Payors are required to notify recipients of their rights to elect no withholding. Since the new rules are effective for payments after 1982 (though regulations may extend this to June 30, 1983, for hardship cases), those notices will have to be prepared in relatively short order.

More—and More—Information Reporting

Apparently convinced that the underground economy should carry its share of the tax burden, Congress has instituted a number of new requirements for reporting information to the Internal

Revenue Service as well as to income recipients. Most of the changes concern interest payments.

INTEREST REPORTING

The definition of reportable interest has been expanded and, just in case some type of interest is not included in the definition, the Secretary is authorized to include it by regulation. There are increased reporting requirements by intermediaries between the payor and the payee. The Secretary is authorized to issue regulations providing for information reporting by financial institutions, brokers, and other intermediaries on a transactional rather than an aggregate annual basis.

OBLIGATIONS REQUIRED TO BE REGISTERED

Supportive of the increased requirements for information reporting of interest, the Act discourages the issuance of bearer instruments to the general public by denying certain tax benefits unless bonds are issued in registered form and by prohibiting the issuance of bearer obligations by the federal government. Interest on state and municipal bonds, too, will suffer a tax "disincentive" if the bonds are not registered—it will not be exempt from federal taxes. Obligations issued by natural persons, or those of a type not offered to the public, and those with a maturity at issue of less than one year (that is, most commercial paper) need not be registered. There is an additional exception for obligations which can be issued only to a party that is not a United States individual or entity and the interest on which is payable only outside the United States.

If a corporate obligation is required to be registered but is issued in nonregistered form, the issuing entity will not be permitted to deduct the interest on it, nor will there be a reduction in earnings and profits for such interest paid.

A further encouragement to the registration of required obligations is the imposition of an excise tax on the obligation in the event of nonregistration; the tax equals 1 percent of the principal amount multiplied by the number of years for which it is issued.

ADDITIONAL INFORMATION REPORTING BY BROKERS AND INTERMEDIARIES

The definition of a broker has been expanded to include a dealer, a barter exchange, and any other person or entity regularly acting as a middleman. Details of the information to be submitted by brokers is left for regulations, but reporting will have to be to customers as well as to IRS. The Act also extends the definition of third-party record-keepers to include barter exchanges. This is effective for summonses served after 1982. The new information reporting by commodities and securities brokers are to be spelled out in regulations required to be issued within six months after the new law is enacted, but the regulations are not to be applied to transactions occurring before 1983. Current information reporting by barter exchanges takes effect on the date of enactment.

OTHER INFORMATION REPORTING

There has been some strengthening of the requirement for reporting payments for services amounting to $600 or more. The requirement is still limited to payments made by a person engaged in a trade or business, but it applies to payments for any performance of services. It is not clear whether corporate service providers will remain exempt from being reported, as they are now (by regulation, not by statute). There are also new information reporting requirements covering payments made by direct sellers of consumer goods to buyers, for resale in the home or otherwise than in a permanent retail establishment.

State and local governments are required to provide information to IRS regarding all refunds, credits, and offsets of state and local income taxes.

EXPANDED PENALTIES

To ascertain that the new reporting requirements do not produce a "paper tiger," Congress has given its new creation some claws. The three new areas of reporting (brokers, service providers, direct sellers) are all brought within the purview of the Code sections providing penalties for nonreporting. And, those penalties for *all* information reporting forms (including dividends and interest) are raised from $10 to $50 per missing or late-filed information return. Still more stringent penalties are possible for intentionally disregarding the reporting rules.

Under these circumstances, it will become substantially more important for information reporters to obtain the correct tax identification number of each person to whom payments are made. To assist them in this endeavor, the penalty for failure to supply an identification number is increased from $5 to $50, unless such failure is due to reasonable cause and not to willful neglect.

The provisions regarding reporting payments for services and sales apply to payments after 1982.

One final caution: the Senate Finance Committee, in its report on these provisions (which were adopted in conference virtually without change) noted:

> Although the committee is aware that the penalty for failure to file information returns has been little used in the past, it intends that the Internal Revenue Service will use this increased penalty more fully to protect the information reporting and withholding systems.

Reporting on Restaurant Tips

Though a waiter's salary may be the bread he brings home, Congress apparently believes that tips are the gravy and that any server worth his or her salt should, as a minimum, earn tips equaling 8 percent of the check for the meals served, or else be prepared to explain to IRS an apparent lack of professional aptitude.

Here's what the rules will look like, effective for calendar 1983. First, we need to understand a new term, namely "large food and beverage establishment." The statute describes that as any public or private activity which provides food or beverages for consumption on the premises (other than of a carry-out nature, such as fast-food restaurants), with respect to which tipping is customary, and which normally employed more than 10 employees on a typical business day during the preceding calendar year. Thus, the more typical restaurants, diners, luncheonettes, etc., will be subject to new rules.

These establishments will have to report to the Treasury:

- Gross receipts from food and beverages
- Total charge (credit card, etc.) receipts
- Tips shown on charge slips
- Tips already reported to the employer (nothing new here)
- Certain service charges
- The amount of tips allocated to each employee. Essentially, this is an amount to bring his or her total reported tips up to 8 percent of the receipts for related meals and drinks.

Note. If the employees, as a group, voluntarily report tips aggregating 8 percent or more of gross receipts, then no tip allocation will need to be made.

Income tax and FICA withholding requirements are unchanged (for "large" and smaller establishments). However, to the extent that this provision results in waiters reporting increased amounts to their employer, FICA and FUTA tax liabilities will be increased.

Observation. These provisions represent a compromise between the former, looser reporting requirements and the actual withholding on tips that was included in the Senate Finance Committee version of the Act. The full Senate refused to sanction a withholding approach, but did vote instead to disallow one-half the cost of most business meals as a tax deduction. That change did not survive the conference. We anticipate continued interest by the Treasury, however, in compliance by waiters under these more stringent reporting requirements, and we suspect the issue will be with us again in a few years.

Penalties

In enacting the TEFRA compliance provisions Congress was not satisfied to require additional information reporting or, in the case of interest and dividends, to impose withholding for the first time; several new penalty sections give substantial teeth to the Commissioner's attempts to deal with some of the more abusive aspects of tax avoidance. As discussed above, substantial increases have been enacted in some of the "nuisance" penalties, such as those for failure to file information reports or to furnish tax identification numbers; the ones described in this section are for more serious acts and are, accordingly, more severe.

Three new penalties, though not criminal, are serious enough so that the government (rather than the taxpayer) is required to carry the burden of proof. The first is against an organizer or promoter (or any person participating in sales of interests) of an "arrangement," if that person either makes or furnishes a statement concerning the securing of any tax benefit which he knew or had reason to know was false or provides a valuation of property over twice the actual value. The penalty is the *greater* of $1,000 or 10 percent of the gross income to be derived from the activity by the promoter or other person participating in the sale—and it is specifically stated that this penalty is in addition to any others provided by law.

Caution

- The "promoter" penalty may provide a false sense of comfort to the tax shelter investor and/or his tax return preparer. It does not absolve either of them from penalties for understatement of tax liability (whether by fraud, negligence or otherwise). Moreover, it is also possible that a promoter may simply "gross-up" his commission or fee to cover the added cost of the penalty.
- The statute does not provide a de minimis exception with respect to false or fraudulent statements concerning tax benefits. A false statement regarding small dollar amounts (say, a $100 deduction) could, theoretically at least, result in a penalty of $1,000 or more.

The second of the three penalties for which the government bears the burden of proof concerns any person aiding or advising in the preparation or presentation of any document (including returns) connected with a matter arising under the internal revenue laws, where such person knows the document will be used in compliance with those laws but will result in "an understatement of the liability" for tax. The penalty is $1,000, except that where the taxpayer is a corporation it shall be $10,000. Again, it is imposed in addition to any other penalties provided by law. However, it will not be imposed where IRS chooses to assess a "preparer penalty" instead. While those preparer penalties are smaller, the government does not carry the burden of proof in proposing them, so the distinction is more than academic.

Finally, for filing a "frivolous" return (presumably of the "tax protester" type), a $500 penalty is provided, in addition to any others already in the law. Interestingly, this penalty applies even in cases where the correct amount of tax is paid with the return.

The first two of the above three penalties take effect "the day after the date of . . . enactment." The third penalty, for frivolous returns, is effective for "documents filed" after date of enactment.

SUBSTANTIAL UNDERSTATEMENTS

A final penalty worth some discussion here is aimed at what appears to be "big ticket" items of virtually any sort on a tax return. It is somewhat complicated, but can have broad impact. The penalty is for "substantial understatement" of tax liability, and it need not arise in a tax-shelter context.

For a noncorporate return, "substantial understatement" is defined to be 10 percent of the tax required to be shown on the return, but it must be at least $5,000 for the penalty to apply. For corporate returns, the understatement must be at least $10,000. The amount of the penalty is 10 percent of any underpayment attributable to the defined understatement of liability. Unlike the three penalties described above, the taxpayer retains the burden of proof to show the penalty does *not* apply.

If an understatement exists, the standards for determining whether the penalty applies will depend on whether the items giving rise to it are from tax-shelter or non-tax-shelter activities. As a result, the investor must determine the nature of activity (that is, tax-shelter vs. non-tax-shelter) to adequately assess how aggressive a tax posture he may assume without incurring the added risk of the penalty. For purposes of this penalty, a tax shelter is defined as any "arrangement" (including limited partnerships and investment plans) whose "principal purpose" is "the avoidance or evasion of federal income taxes."

NON-TAX-SHELTER ITEMS. Where items falling outside the tax-shelter definition give rise to a substantial understatement, the penalty will apply unless one of the following two circumstances exists: (1) the relevant facts are "adequately disclosed" in taxpayer's return or an attachment to it; or (2) there is or was "substantial authority" for the position taken on the return.

Neither "adequate disclosure" nor "substantial authority" is defined elsewhere in the Internal Revenue Code. Both may be expected to be debated while the regulation-writing process goes on, as well as in subsequent litigation. The conference committee report disposes of the question of "adequate disclosure" by pointing out that under applicable regulatory authority, the Commissioner of Internal Revenue "may prescribe" the form of such disclosure. Under such circumstances, it would not be unreasonable to expect from IRS a rather expansive vision of how much disclosure will be considered "adequate."

The question of "substantial authority" comes in for a good deal more attention by the conferees in their report. It is, as they point out, a new standard, with a decided lack of judicial or administrative decisions interpreting the phrase. The committee report recognizes the need to consider court opinions, Treasury regulations, IRS revenue rulings and revenue procedures, and Congressional intent as reflected in committee reports on tax legislation.

It is interesting to note that, while published IRS rulings and procedures may support a taxpayer's position, the conference committee discussion of the issue states that courts will not be bound (in determining whether there is substantial authority) by "private ruling or determination letters and technical advice memoranda of the Internal Revenue Service," or law review articles and opinion letters; but rather will examine the authorities underlying those expressions of opinion. With respect to private letter rulings of the IRS, that language is consistent with the Service's insistence (supported by statute) that private rulings are without precedential value. Still, it will be interesting to see whether a court allows an understatement penalty to be assessed on the grounds that a letter ruling issued by the Service (although to another taxpayer) does *not* help the present taxpayer show "substantial authority" for his position.

Finally, with respect to non-tax-shelter activities, an opinion from a competent tax adviser is likely to take on even more importance with respect to tax questions of materiality—particularly in the seemingly ever-growing "no-rule" areas where IRS declines to issue private rulings to taxpayers who request them. While the conference committee report notes that courts will be bound, not by such opinion letters, but by the authorities underlying their conclusions, the issuance of well-reasoned and well-supported opinion letters should go far in reassuring taxpayers that they have "substantial authority" for their positions.

TAX-SHELTER ITEMS. There are two important differences in the standards for the understatement penalty between non-tax-shelter and tax-shelter items: first, in addition to the "substantial authority" requirement, another, more stringent standard also applies and, second, *disclosure of the questionable item is not an alternative for avoiding the penalty.*

If an item in question arises from circumstances meeting the definition of a tax shelter (arrangement whose principal purpose is avoidance or evasion of federal income taxes) the substantial understatement penalty will apply, unless the taxpayer both has substantial authority for his position and "reasonably believed" the treatment of the item on his return was "more likely than not" proper. "More likely than not," also not defined elsewhere, requires a more-than-50-percent reasonable belief. And, the practical application of the rule will doubtless be most difficult. For example, the understatement may arise from a number of different items, all as part of one tax-shelter investment, which—taken together—aggregate the requisite deficiency. Is it required that, for each specific subset of the understatement, there be a "more likely than not" belief? Or, is the standard satisfied if the taxpayer can demonstrate that, taken as a whole (as these investments must be), he had a reasonable "more likely than not" belief that he would obtain, say, 80 percent of the tax benefits offered by the shelter investment.

Note that if the taxpayer cannot demonstrate the required level of belief, disclosure of the item or items on the return will not avoid the penalty, unlike the situation for nonshelter activities. Note also that the inquiry for determining application of the penalty in the shelter context is not whether the taxpayer was more likely than not to prevail (a highly subjective test in itself) but whether the taxpayer *reasonably believed* his position was more likely than not correct (thus potentially making subjectivity ever so much more so, and possibly placing a premium on the ignorance of the taxpayer).

There is one final point about the definition of tax shelters in this section. The statutory language used is identical to long-standing language in the Code involving corporate acquisitions or the obtaining of corporate control. There is, therefore, a rather extensive body of litigation defining when "the principal purpose" of an acquisition is the avoidance or evasion of federal income taxes. Importantly, the courts have determined that "the principal purpose" does not connote a greater-than-50-percent purpose; it will be sufficient if the tax avoidance purpose represents a plurality of the various purposes involved. If, for example, there are 10 nontax reasons for a shelter investment, each of which represents 9 percent of the basis for deciding to invest, but the one tax avoidance reason represents the other 10 percent of the basis for investment, the principal purpose will be deemed tax avoidance.

On the other hand, it is interesting to note that the amount of litigation about the meaning of the phrase in the corporate context has dropped substantially over the past several years. Presumably, there are other provisions of the Code that permit the Service to attack tax-motivated corporate acquisitions in ways that promise more likelihood of success than trying to determine what "the principal purpose" was. While we doubtless should anticipate some litigation on this subject, it must be remembered that the $5,000 or $10,000 floor will make the penalty less of a threat to many tax-shelter investors.

The substantial underpayment penalty takes effect for returns with original due dates that fall after 1982. Thus, a taxpayer with a fiscal year ended September 30, 1982, who obtains an extension to March 15, 1983, for filing its return due December 15, 1982, will not be subject to the new provisions with respect to its fiscal 1982 return. On the other hand, a taxpayer filing a return April 15, 1983, with an investment credit or loss carryover from, say, 1981, might find himself the subject of a penalty based on the 1981 transaction. We will have to wait for regulations.

Deficiency Interest and Interest on Refunds

There are three significant changes to the rules for computing interest on late payments of taxes and on refunds the Treasury owes taxpayers. First, interest on both late payments and refunds (which, at present, is computed at annual, simple interest) will be compounded daily, thus altering the factors to be considered both in "playing the audit lottery" and in timing the filing of refund claims. This change applies to interest accruing after 1982. Second, the interest rate charged on deficiences and paid on refunds will be determined semiannually rather than annually. The rate will be based on the prime for six months ending September 30 and March 31, and the new rate will be effective for 6-month periods starting January 1 and July 1, respectively. Third, if a return is filed late, the government will not be required to compute interest on refunds for the time before the return was actually filed.

For a refund caused by a carryback, the 45-day rule is made applicable to the payment of interest on the refund. If IRS refunds the tax within 45 days of the filing of the Form 1139, *no* interest will be payable, regardless of when the carryback claim is filed. This provision will certainly encourage the Service to make relatively prompt refunds—it will also encourage taxpayers to file carryback claims promptly and avoid loss of interest for significant periods.

The new rule is illustrated by the example shown in Table 8-1, which uses a calendar 1982 year loss corporation.

The provisions relating to late returns apply to those filed after the 30th day following the date of enactment. The provisions relating to interest on carrybacks apply to interest accruing after the 30th day following the date of enactment. Thus, 1981 loss taxpayers that have delayed filing their carryback claims have no

Table 8-1

Return Filed	*1139 Filed*	*Refund Within 45 Days of 1139*	*Interest Runs From*
3/15/83	9/15/83	No	3/15/83
9/15/83	9/15/83	No	3/15/83
3/15/83	9/15/83	Yes	No interest

further incentive to do so. Since the law will almost certainly have been enacted as you read this, filing the claim today will presumably entitle a taxpayer to interest on the carryback up to the 30th day after enactment, but no further—so long as the refund is paid within 45 days.

There is one interesting historical sidelight to this discussion. The TEFRA restrictions on loss carryback interest are clearly aimed at the 1982 statutory interest rate of 20 percent, with numerous loss businesses delaying the filing of a loss carryback claim until the latter part of 1982 to obtain maximum interest on 1981 losses. Yet, as this booklet goes to press (August 28, 1982), the prime rate has dropped to 13½ percent, which becomes a possible September 30 rate, and thus one with a reasonable chance of being the determinant of statutory interest on deficiencies and refunds for the six months starting January 1, 1983. Given the levels of commercial, nonprime lending rates today, business strategy may well shift back in the other direction next year: to delay *payments* to IRS as long as legally possible, as the borrowing rate from the government may be lower than companies can expect to obtain in the private sector.

Administrative Summons

The 1976 Tax Reform Act placed some new limitations on the ability of the IRS to examine third-party records by merely issuing a summons requiring that they be turned over to the Service. Under the 1976 changes, a taxpayer was entitled to be notified of the issuance of the summons, and had the right to stop the recordkeeper (bank, accounting firm, etc.) from complying with the IRS summons merely by instructing it in writing not to do so. At that point, it became the responsibility of the government to sue in a district court to have the summons enforced.

TEFRA swings the pendulum part way back. Effective for summonses issued after 1982, it will not be enough for the taxpayer to notify the third-party record-keeper not to comply. Rather, the *taxpayer* will have to initiate proceedings in a district court to quash the summons, and will have 20 days after the date of issue to initiate such action. The records need not be produced until the 23rd day after issue, but the record-keeper will be required to assemble documents (for which he or she will be reimbursed by the government) in compliance with the summons so that, should the taxpayer not take appropriate steps to quash, the material will be available for IRS on the return date.

What we may anticipate is a substantial slackening of summons activity between now and the end of 1982, followed with a "catch-up" in the early part of 1983, when the new rules become effective.

The Act contains a much-needed clarification of the restrictions on use of an administrative summons where criminal prosecution is contemplated.

Taxpayer Reimbursement for Litigation Costs

Until 1980, a taxpayer intending to sue the government in connection with tax matters needed to consider very carefully the potential litigation costs, for he, she, or it could readily win the tax battle but lose the economic war due to the expense. The Equal Access to Justice Act of 1980 provided slight—but only slight—relief by allowing taxpayer recovery of litigation costs if the government's position was not substantially justified. And costs connected with Tax Court litigation could not be recovered at all.

TEFRA provides slight, additional relief, including the awarding of costs in Tax Court actions. Under the Act, winning taxpayers in civil proceedings may be awarded a judgment for "reasonable litigation costs," up to $25,000. To protect the government against too hasty litigation, the awarding court must determine that taxpayers had first exhausted their administrative remedies within the IRS.

"Reasonable costs" may include court costs proper, as well as those for expert witnesses, studies, analyses, engineering reports, tests, attorneys, etc.

The major limitation on a taxpayer's likelihood of success here is that he or she must establish that the position of the United States was "unreasonable," and that he or she had prevailed on the most significant issue(s). This may or may not be a more difficult test to sustain than showing the government position not to be substantially justified.

Can a taxpayer bring several actions simultaneously with the hope of collecting multiple $25,000 awards? Not so; if the actions can be joined in a single proceeding, they must be consolidated.

Caution. Note that the new section is a two-edged sword. The penalty for using the Tax Court as a delaying device (to avoid assessment) or to present a frivolous position has been raised to $5,000, from its former $500.

The new reimbursement rules apply to civil proceedings initiated after February 28, 1983, but sunset for actions commenced after 1985. The Tax Court delay penalty increase is for actions started in that court after 1982.

9

Partnership Audits and Litigation

Points to Consider

- Partnerships continue to be tax "conduits" which are not themselves taxable. However the tax treatment of their income and expense items will, for the first time, be audited and settled at the partnership level and, generally, all partners will be bound by the results.
- The partner in charge of keeping the IRS informed of partnership tax matters is designated "tax matters partner." He or she will be under increased pressure to report various matters to the IRS and to fellow partners. This role becomes even more complicated in a multi-tiered partnership.
- All members of partnerships will need to become aware of their rights and safeguards under these new rules; limited partners, in particular, will have to understand how decisions made by one general partner can affect their interests.

Under pre-TEFRA law, a partnership is not a taxable entity. It files an information return but pays no tax. The tax liability for items of partnership income and deduction is determined at the partner level. Because a partnership is not a taxable entity, tax liability cannot be adjusted at the partnership level, but rather all adjustments are made to each partner's income tax return. A settlement agreed to between the IRS and any partner is not binding on any other partner. Also, a court determination of a partner's tax liability is only conclusive with respect to partners who are parties to the court case.

For many years, the IRS has had difficulty in auditing and assessing all returns of partners in a partnership before the statute of limitations expired. Further, there was an enormous backlog of partnership cases in the Tax Court. TEFRA changes to partnership audit procedures are aimed at unifying the process so that partnership audits will be centralized.

For partnership taxable years starting after date of enactment, the tax treatment of partnership income, losses, deductions, and credits will be determined at the partnership level in a *unified* partnership proceeding. A partnership can also elect to have these provisions apply for the current year. A brief description of the provisions implementing this general principle follows:

Administrative Proceedings before IRS

Each partner is required to treat partnership items on his return consistently with their treatment on the partnership return. The consistency requirement is waived if the partner files a statement with his return, identifying the inconsistency. Also, the consistency requirement may be waived if the partner receives an incorrect schedule. However, failure to satisfy the consistency requirement, if not waived, will result in adjustments to the partner's return.

Each partner whose name and address is furnished to the IRS will be notified of a partnership-level audit as well as of the Final Partnership Administrative Adjustment (FPAA). However, partners with less than a 1 percent interest in partnership profits in partnerships of more than 100 partners need not be notified. Notice to a partner designated as the tax matters partner (TMP) is treated as notice to these "small" partners.

One safeguard is available to "small partners." A group of small partners with a *total* interest of at least 5 percent may designate one of its members to be a "notice partner" whom the TMP will have to notify on behalf of the entire group.

Designation of the TMP will be important to the partnership, as he will be the lead partner in all administrative dealings with the IRS on behalf of the partnership. In general, he or she will be a general partner to be designated in forthcoming regulations, or the partner with the largest profits interest, or (as a default procedure) a partner designated by the IRS. Query: what, if any, will be the procedure for replacing a TMP who does not satisfy the needs of fellow partners?

The TMP will be required by regulation to keep partners informed of all administrative and judicial proceedings. All partners have a right to participate in partnership proceedings but may waive such right. The unanswered question here is what exactly that participation will entail, especially in terms of settlement authority.

Any deficiency resulting from administrative determination generally may not be assessed until 150 days after mailing the FPAA to the TMP or, if a Tax Court proceeding is begun during the 150-day period, until the court decision is final.

Judicial Proceedings

Within 90 days after the mailing of the FPAA to the TMP, the TMP may file a petition in the Tax Court, the district court for the district in which the partnership's principal place of business is located, or the U.S. Claims Court (formerly known as the Court of Claims). During the 90-day period, no other partner may file a court petition. However, if the TMP does not begin a court action within 90 days, any other partner receiving notice may do so in the same courts mentioned above between the 91st and 150th day. Only one court proceeding may go forward; however, the first petition filed in the Tax Court will take precedence. Any preceding or subsequent petitions filed in another court will be dismissed. The TMP can intervene by joining in a petition brought by another partner, but that other partner will already have decided the forum. Any other partner with an interest in the outcome will also be allowed to participate.

Please note that one effect of this unifying procedure in court actions is to restrict individual partners as to their right to litigate their own tax liability for partnership items in the forum of their choice.

Note, too, that the partners litigating in a district court or the U.S. Claims Court would first have to pay the disputed tax and then sue for a refund. Therefore, as a condition to filing a petition in the district court or the Claims Court, the petitioning partner must deposit with the IRS the amount his or her tax liability would be increased if the final decision is consistent with the FPAA. If the partnership prevails in court, the deposit will be returned, with interest.

The court to which the petition is brought will have jurisdiction to determine all partnership items to which the FPAA relates.

Requests for Administrative Adjustment

A partner may file a request for administrative adjustment of partnership items with the IRS within three years after the partnership return was filed and before the mailing of FPAA to the TMP. A request for administrative adjustment is a request by a partner to the IRS for change in the treatment of partnership items as shown on the partner's return. If that request is filed by the TMP, it may serve as an amended return and/or claim for refund. Also, each partner may file a request for administrative adjustment on his or her own behalf. With respect to any disallowed part of the requested adjustment, the TMP or the individual partner may file a petition for judicial review from six months to two years following the date of filing the original request.

Statute of Limitations

The assessment period with respect to partnership items is generally the later of three years from the filing of the partnership return or the last day the return could have been filed, excluding extensions. Assessments can be made at any time against partners participating in a fraudulent return. Also, if 25 percent or more of gross income is omitted on the return, the assessment period is six years.

As mentioned above, IRS will be prohibited, on the one hand, from making an assessment from the date of mailing of the FPAA until the 150-day period for bringing a court action expires. On the other hand, the statute of limitations is extended by one year following the 150-day period, or the final court action (whichever is later).

Separate rules are provided to deal with requests for computational adjustments where the issue is the computational method to be applied to adjust a partner's return.

Other Rules

1. Generally, the period of limitations provided for assessments will also apply to the allowance of credits or refunds.
2. When notice of commencement of a partnership proceeding is mailed to the TMP, he or she is required to furnish to the IRS names, addresses, and identifying numbers of all partners.
3. The above rules do not apply to partnerships consisting of ten or fewer partners, all of whom are natural persons (other than nonresident aliens), if each partner's share of any partnership item is the same as his distributive share of every other partner-

ship item. A husband and wife will be treated as one partner for this purpose. However, a partnership to which the audit rules do not apply can elect to be subject to them.

4. In certain limited situations, partnership items of any one partner can be treated as a matter separate from the partnership; in other words, the IRS can in those situations avoid the cumbersome notification requirements. Existing administrative rules on the treatment of partnership adjustments on an individual return in administrative and judicial proceedings will continue to be in effect.

5. The partnership return filing requirements apply to any partnership with U.S. partners. Where the TMP resides outside the United States, or the partnership's books are kept outside the United States, failure to comply with the return requirements will result in the disallowance of partnership losses and credits. U.S. partners acquiring or disposing of interests in foreign partnerships will be required to report the transactions to the IRS.

6. Windfall-profit tax items for partnerships will also be determined at the partnership rather than at the partner level effective for taxable periods beginning after 1982.

10

Employment and Excise Taxes

Points to Consider

- **Certain real estate agents and direct sellers have had their status as independent contractors clarified. For all others, the common-law tests continue to apply.**
- **Unemployment benefits will be payable longer, but taxes on them can be higher—retroactively.**

Independent Contractors

After a 3-year struggle, it appeared that Congress was finally going to come to grips with an issue that has been extremely troubling to taxpayers, the IRS, and Treasury for some time: the question of when many working individuals are considered independent contractors and, therefore, self-employed. Congress came close but ultimately ducked the issue for most, while solving the question for two important groups.

The issue is more than academic. Independent contractors are not subject to federal income tax withholding by persons or companies for whom they provide services; nor is social security or unemployment insurance withheld or paid on their behalf. Their tax liability is to be satisfied by filing estimated tax returns and paying an additional self-employment social security tax. Other things being equal, both providers and recipients of services seem to prefer the independent contractor status. The recipient has substantially less bookkeeping and no accounting to the IRS, other than information reporting of payments exceeding $600 during the year. The provider has the opportunity to tailor tax and social insurance payments more closely to his or her actual economic circumstances and possibly to derive some benefit from the use of money for a longer period.

The IRS, on the other hand, has a somewhat different view of the problem. In its judgment independent contractors, as a class, are significantly lower in tax compliance than is the class of employees for whom withholding from wages is a part of life. And the issue is not so much a question of *under*reporting of income by independent contractors, but the *non*reporting of income. Accordingly, the IRS has pursued vigorously the reclassification of individuals from self-employed to employee.

While the tax laws have provided some statutory or regulatory definitions, and even some specific illustrations of who is an employee, the general tests have applied some 20 common-law factors defining whether the relationship between service provider and recipient is that of employer to employee. The tests, however, are subjective, and the increased litigation (and outraged letters) resulting from the Service's pursuit of self-defined contractors finally caused Congress to act. As part of the 1978 Revenue Act, it terminated some of the pre-1979 controversies involving employment tax liability. It also prohibited, through 1980, the issuance of regulations or rulings changing the common-law rules, and a subsequent bill extended that freeze through June 30, 1982.

The Senate version of TEFRA adopted a substantive approach that would have allowed a taxpayer certainty of status as a self-employed independent contractor if he or she met five "safe harbor" tests. The concept—and the five tests—were originally introduced in 1979 by Congressman Richard Gephardt of Missouri, but his bill had never come to fruition. This year, it appeared his approach might be successful.

However, not so. The Act provides, instead, that licensed real estate agents and direct sellers will be treated as independent contractors, effective for services performed after 1982, provided substantially all remuneration (cash or property) is based on sales rather than hours worked (commissions as opposed to salary), and it is earned under a written contract stating the individual will not be treated as an employee for federal tax purposes. Interestingly, these were two of the five safe harbor standards in the Gephardt approach. The Act also limits and spells out the employer's tax liability for employment taxes when the employer erroneously treats the person as not being an employee.

Two important groups of service providers are now covered. For all the other classifications, the freeze on regulations and rulings is extended, indefinitely. Beginning July 1, 1982, there is no longer a time limit on that freeze. Perhaps the message is that Congress does not want to take up this issue again for some time to come.

The saga continues. . . .

Excise Tax Provisions

AIRPORT AND AIRWAY TAXES

The domestic air-passenger ticket tax is increased to 8 percent from 5 percent. TEFRA also imposes a 5 percent tax on air-freight waybills. A $3 per-person international departure tax is reimposed. Several tax increases on aviation fuels and aircraft tires, no doubt, will also be felt by consumers, through increased ticket costs. The changes are effective September 1, 1982.

CIGARETTE EXCISE TAXES

The cigarette excise tax, currently eight cents per pack, is doubled to 16 cents, effective January 1, 1983, and continuing through September 30, 1985.

TELEPHONE EXCISE TAXES

Under current law, the federal excise tax on local and long-distance telephone services is 1 percent. This tax was scheduled to expire after 1984. TEFRA increases the rate to 3 percent for calendar years 1983 through 1985, with scheduled expiration thereafter.

Unemployment Benefits and Taxation

The new law provides additional federally funded unemployment compensation benefits effective September 12, 1982, through March 31, 1983. The benefit period for workers will vary by state from six to ten weeks, depending on various factors, including whether extended benefits were paid after June 1, 1982. To qualify, unemployed workers must have exhausted their state benefits and continue to otherwise qualify for state assistance. Both benefits and administrative costs of the program will be federally financed.

However, indicating one more time that what Congress gives in one section it can take back with another, the Act lowers the income thresholds above which recipients of unemployment compensation become subject to tax on their benefits. The thresholds are reduced from $20,000 to $12,000 for single taxpayers and from $25,000 to $18,000 for married taxpayers filing jointly.

The change is effective for amounts paid after 1981, but any taxable income increase in 1982 due to this change will not support a penalty for underpayment of estimated tax.

Federal Unemployment Tax (FUTA) Provisions

Under current law, the FUTA payroll tax on employers is 3.4 percent of the first $6,000 in wages paid to each employee. However, if the applicable state's unemployment compensation program meets the requirement of federal law, employers in the state receive a 2.7 percent credit against the 3.4 percent tax—reducing the effective net FUTA tax rate to 0.7 percent.

Under the TEFRA amendments, the FUTA wage base will increase from $6,000 to $7,000 and the FUTA tax rate will increase from 3.4 percent to 3.5 percent. Employers in states with approved state programs will continue to receive the 2.7 percent offset credit, so that the standard net FUTA tax rate will increase to 0.8 percent. This change is effective January 1, 1983.

Beginning January 1, 1985, the gross FUTA tax rate will increase to 6.2 percent; however, the credit offset will correspondingly increase to 5.4 percent so that the net tax remains at 0.8 percent on the $7,000 wage base. Certain transitional rules are provided, depending on applicable state unemployment tax rules.

If the state repays all outstanding federal government loans for unemployment benefits, the tax rate will drop to 6 percent, so that the net effective rate to employers will be 0.6 percent.

Other TEFRA provisions exempt from FUTA tax any wages paid to students in internship or work-study programs. Also, for 1983 only, wages paid to full-time students employed by certain summer camps are exempt. Wages paid to certain alien farmworkers are exempt from FUTA taxes until January 1, 1984.

11
International Taxation

Points to Consider

- **Certain payments to foreign government officials will, again, become deductible as ordinary and necessary business expenses.**
- **Substantial changes are enacted in the rules affecting U.S. possessions corporations. Companies removing intangibles from U.S. possessions, however, will be subject to tax.**
- **Foreign-based books and records not produced in response to a formal request by the IRS may not be available as evidence for the taxpayer in subsequent civil tax litigation.**
- **Tax rules on foreign energy income have become more restrictive.**

Deductibility of "Illegal" Payments

Taxpayers who feel that Congress has been trying to legislate U.S. standards of morality in foreign countries by means of the tax laws, may find of interest one of the less publicized sections of the new act. Payments to government officials or intermediaries in foreign countries (which had ranged from "grease" or "facilitating" expenditures to outright bribes) led to a rash of unfavorable publicity some years ago. It culminated in the famous "eleven questions" used by the Internal Revenue Service to determine whether nondeductible payments were being made by businesses, and then resulted in amendments to the "ordinary and necessary" business deduction section of the Code.

Before TEFRA, deductions were not permitted for any payments to foreign government employees or officials if such payments would be illegal under U.S. federal law—*even though completely legal under the law of the affected foreign country*. Now, payments made after the date of enactment will be deductible for U.S.

tax purposes so long as they meet two tests: (1) They must be legal under the law of the foreign country; and, (2) They must not be illegal under the U.S. Foreign Corrupt Practices Act.

The overall effect of the new provision is to permit a deduction for grease or facilitating payments which heretofore had not been allowable. Bribes or other payments abroad to influence official action to obtain business will still not be deductible by a U.S. company, since the payments are covered by the Foreign Corrupt Practices Act.

One other caution on this subject: since nondeductibility is specifically tied by statute to the Foreign Corrupt Practices Act, there will be automatic, corresponding changes in the deductibility of payments under this new section as standards for illegal payments under that Act change.

The new deductibility rules also have a spillover effect. Before TEFRA, nondeductible payments to foreign officials were treated as a current distribution if made by a DISC; and they were considered as income to U.S. shareholders if paid by a controlled foreign corporation (CFC), but without reducing its earnings and profits for future dividend purposes. To the extent that such payments now become deductible, they will no longer affect DISCs or CFCs as they had in the past.

U.S. Possessions Corporations

Many U.S. corporations with significant operations in Puerto Rico are effectively exempt from U.S. tax. The purpose of this exemption is to attract companies to Puerto Rico and to encourage job creation and investment in depreciable property there.

Because the Island affiliate operating in Puerto Rico, known as a "possessions corporation," is effectively exempt from U.S. tax, while its mainland parent is fully taxable, there is an obvious incentive to have the Island affiliate earn as large a share of profits as is permissible.

In general economic terms, a company which manufactures and sells products earns a profit from two distinct activities: manufacturing and marketing. The rate of return from manufacturing will vary depending on the nature and ownership of "manufacturing intangibles." For example, a company owning a patent on a product in great demand may be able to command a high manufacturing profit primarily because of that patent. At the other extreme, a "contract manufacturer," which merely assembles a product for another—in return for an assembly fee—may be entitled only to a relatively small manufacturing profit.

Similarly, the rate of return from marketing will vary, depending on the nature and ownership of "marketing intangibles." For example, a company with a brand name or a trademark may command a higher marketing profit than one selling a generic product.

If a U.S. parent develops manufacturing and marketing intangibles and then transfers their ownership to the Island affiliate, the lion's share of the manufacturing and marketing profit will lodge in the tax-exempt Puerto Rican based operation, while the parent will have expensed the development costs against its taxable profits.

Thus, because the purpose of the possessions corporation exemption is to promote job creation and investment in depreciable property in Puerto Rico, the question of how transferring manufacturing and marketing intangibles to the Island affiliate furthers that basic purpose has existed for some time. Apparently, Congress has finally perceived such transfers as a raid on the Treasury, and has taken steps to reverse it.

TEFRA scales back the effective tax exemption of the Island affiliate by carving out a *portion* of the profit attributable to manufacturing intangibles and *all* of the profit attributable to the marketing intangibles, and generally placing the carved out portion in the U.S. parent. The Act accomplishes this by initially analogizing all Island affiliates to "contract manufacturers" (a term not used in the statute) entitled to "reasonable profits" only on their direct and indirect production costs. This "reasonable profit" (to be determined by the IRS) will probably be up to 30 percent on total costs incurred by the Island affiliate. Any income of the Island affiliate attributable to intangibles (both manufacturing and marketing) will be subject to U.S. tax.

To avoid this complete scale-back of intangible property income, an Island affiliate can elect irrevocably one of two methods for determining its income: The cost-sharing method or the 50/50 split-of-combined-taxable-income method.

COST SHARING METHOD

The cost sharing approach provides that if the Island affiliate pays its pro rata share (based on sales) of the multinational's worldwide R&D expense, it is treated as owning the manufacturing intangibles (and hence entitled to the profit thereon) in computing its income. The remainder of the Island affiliate's income (that is, apart from the return on manufacturing intangibles) is then computed under normal "arm's length" intercompany pricing standards.

However, because of the difficulty and subjectivity of such standards, we would expect the cost sharing method will not resolve many pricing disputes between taxpayers and the IRS. The approach does resolve the question (currently being litigated) of *who* is entitled to the return on the manufacturing intangibles (in exchange for the cost sharing payment); but it does not help determine what rate of return should apply to the manufacturing intangibles. Nor does it answer the more basic question of what the correct intercompany price, excluding the rate of return on manufacturing intangibles, should be.

Leaving aside these fundamental questions, there are several troublesome points about the cost sharing method itself. First, it is difficult enough to determine precisely what is meant by "research, development, and experimental" costs for any purpose. When this difficult aggregate determination must be subdivided into "product areas" (defined by reference to sales classified at the 3-digit SIC code level) for each domestic and foreign subsidiary, the problem is compounded. What, for example, does one do with "basic" research which is not specifically associated with any single 3-digit SIC code? Treasury attempted to answer an analagous question some years ago, in the U.S./foreign-source income regulations, and decided a heating manufacturer had to allocate basic R&D to a dividend from a hotel subsidiary—an approach not designed to fill one with confidence about how the instant question will be addressed.

Second, in determining the Island affiliate's "pro rata" share of worldwide R&D, the formula used requires a "tracking system" to ascertain sales of the Island affiliate's products to third parties. For example, sales of Island affiliate products to a U.S. parent, when some of those products are, in turn, sold to foreign subsidiaries for resale abroad, requires the foreign subsidiary, as well as the U.S. parent, to report these third-party sales.

Third, those Island affiliates choosing the 50/50 combined-taxable-income method (discussed below) will nevertheless have to perform the cost sharing calculations. In arriving at combined taxable income, the amount of R&D allocable cannot be less than that determined under the cost sharing method.

50/50 SPLIT-OF-COMBINED-TAXABLE-INCOME METHOD

The 50/50 method is far more objective than cost sharing and is, in many respects, patterned after the 50/50 DISC pricing method. However, it has its own set of problems. For example, the method tends to place a ceiling on the amount of profits that can be earned by the Island affiliate. It therefore tends to undermine the fundamental "arms length" principle in the Code and in our treaties.

The cost sharing method focuses on "product areas." The 50/50 method, instead, focuses on individual products. The Island affiliate and its related U.S. parent will be required to determine the taxable profits derived by each party for each individual product.

The unanswered question is "What is a product?" Are different sizes of the same widget treated individually or collectively? Is a 200-pound bottle of aspirin a different product from a 100-tablet bottle of aspirin—or is aspirin the product? Does it depend on whether the product is a separate catalog item? The present guidance in the DISC regulations ("a recognized industry or trade usage") is not particularly helpful. In addition, whether some form of "grouping" (as in the DISC rules) will be allowed remains to be seen.

ELECTION

To be eligible to elect either method, the Island affiliate must have a "significant business presence" in Puerto Rico. This test may be met in one of two ways: (1) 25 percent of the value added by all affiliated corporations must be added by the Island affiliate in Puerto Rico, or (2) 65 percent of the direct labor costs of all affiliated corporations must be incurred by the Island affiliate in Puerto Rico. High-margin, low-labor products will have difficulty meeting the first test; Island products produced from U.S. manufactured components will have difficulty meeting the second test.

While the election need not be made until September 15, 1984 (for calendar-year taxpayers with a maximum filing extension), one may need all of the interim to evaluate each alternative. In addition, where there are multiple Island affiliates, the election must be evaluated in the aggregate where product areas within the multiple Island affiliates overlap.

ANTI-TRANSFER RULES

To prevent restructuring the ownership of intangibles to circumvent the new rules, Congress provided certain anti-transfer rules under which it will not be possible to make a tax-free transfer of intangibles from a possessions corporation to a related party. Thus, Puerto Rico need not fear a sudden flight of know-how to related corporations set up in foreign tax havens.

WHAT OF THE FUTURE?

Perhaps the ultimate question stemming from all the above is "How will current and prospective investors in Puerto Rico react to these changes vis-a-vis other countries?" In our judgment, companies with or considering operations in Puerto Rico are unlikely to change their views about Island operations, in general.

- For those companies who have already transferred intangibles to the Island affiliate, the anti-transfer rule above prevents them from transferring the intangibles to any foreign country without incurring a substantial tax payment.
- For those companies who have not transferred intangibles to an Island affiliate, the general arm's-length pricing standards under established tax law remain essentially the same with respect to any country; the safe-haven 50/50 method provides greater pricing certainty than the arm's-length standard, though at the expense of a cap on profits.
- For prospective investors, the certainty of the safe-haven 50/50 method, coupled with the absence of full U.S. tax on later distribution of the subsidiary's operating earnings, will still be seen as favoring Puerto Rico.

Finally, as was the case under prior law, a location choice between Puerto Rico and any other country is far more a business matter than a tax matter. Generally speaking, if goods manufactured for resale are destined for the European market, Ireland has often been the exemption country selected, whereas goods destined for the U.S. market will often be manufactured or assembled in Puerto Rico.

International Compliance

There are several new sections specifically aimed at improving compliance with respect to transactions occurring, or records held, abroad. The most important are set forth in general terms below.

Perhaps one of the more interesting points in this area concerns a section which did *not* find its way into the law. Under the Foreign

Real Property Tax Act, enacted in December 1980, many foreign investors in U.S. real property are now subject to tax by the U.S. for gain realized on disposition of their investments. While reporting requirements were incorporated in the provision, it was recognized in 1980 that noncompliance would likely still be a problem. The Senate version of the 1982 bill required withholding of tax on many such sales; the withholding provision was eliminated in conference, and does not appear in the final Act.

Prior law confers jurisdiction to enforce an IRS administrative summons only if a U.S. resident or citizen is within a judicial district of this country. The Act confers jurisdiction on the District of Columbia district court with respect to any citizen or resident not residing in, or not found in a U.S. judicial district, for any income tax matter involving court jurisdiction or enforcement of summons.

The new jurisdictional rules take effect the day after enactment of the Act.

The conferees also added certain provisions which had been included in a bill considered by the House Ways and Means Committee earlier in 1982. Those provisions initiate a "formal document request" procedure giving the IRS the right to request the production of documents outside the United States, if they pertain to the tax treatment of any item. Failure of a taxpayer to "substantially comply" with the formal request for any foreign-based documentation, can result in that documentation being excluded from evidence in any civil litigation pertaining to the tax treatment of the item for which it was requested. Importantly, the provision applies only to civil tax litigation; criminal litigation is not covered. Note, however, that while a U.S. criminal tax proceeding may not avail itself of these rules, the conference committee report states that, merely because a *foreign* jurisdiction might impose a criminal penalty on the taxpayer for disclosing the requested document, this will not be reasonable cause for a taxpayer withholding that document from the IRS.

The revised rules apply to any formal document requests, meeting the definition of the new section, and mailed after the 1982 law's date of enactment.

Treaty Benefits

Congress, Treasury, and the Internal Revenue Service have for many years been concerned about the proliferation of "treaty shopping," which arises because of reduced rates of withholding on specific income items, in treaties between the United States and another country or between two foreign countries. Illustrative of Treasury's intention to substantially reduce the availability of treaty shopping is the unilateral declaration by the U.S. Treasury which will terminate our tax treaty with the British Virgin Islands, effective January 1, 1983. In a similar vein, negotiations are presently under way with the Netherlands Antilles for substantial changes in that treaty—with the implicit threat that it, too, will be terminated if final decisions are not to the liking of the United States.

Congress has now weighed in, to make certain it is understood that the concern is not just that of executive or administrative agencies. The Secretary of the Treasury is required to establish procedures which would limit treaty benefits so they are "available only to persons entitled to" them. Such regulations are to be prescribed not later than two years after date of enactment.

Foreign Oil and Gas Income

FOREIGN TAX CREDIT LIMITATION

Generally speaking, foreign tax credits are based on the effective U.S. tax rate applied to foreign-source income. For purposes of computing the limitation, foreign-source income is recharacterized ("recaptured") as U.S. source income to the extent that prior foreign-source losses were used to offset U.S. source income in earlier years.

Before TEFRA, the above limitation and recapture provisions were computed separately for foreign taxes on oil-related income and for most other foreign income. Also, for purposes of computing creditable oil and gas extraction taxes, foreign extraction losses from one country did not offset extraction income from other countries. Carryovers and carrybacks of extraction taxes were limited to 2 percent of oil extraction income.

The special foreign tax credit limitation with respect to oil and gas extraction income was enacted originally in 1975, and has since been amended. Its enactment can be attributed to Congress' perception that certain oil exporting countries had adopted unreasonably high rates for taxes applicable to oil extraction income (as much as 80 percent or higher in the post–World War II era), rather than imposing charges of equal amounts and labeling them as royalties.

Generally speaking, TEFRA makes four major changes relating to the oil and gas industry, with the result that the general foreign tax credit rules now apply to most oil and gas activity. The first is to repeal the separate foreign tax credit limitations for foreign oil-related (nonextraction) income and all other (non-oil) foreign-source income. As a result, the general foreign tax credit rules and overall limitation will generally apply to aggregate foreign-source income (which now includes foreign oil-related income). The foreign tax credit limitation on foreign extraction income continues to apply.

As a result of the repeal of the separate limitation rule, post-1982 foreign nonextractive oil income would potentially be subject to recharacterization as U.S. source income in connection with the recapture of pre-1983 foreign non-oil losses. To prevent the immediate recharacterization of oil income in this manner, the distinction between the two types of loss is maintained for pre-1983 losses. However, to prevent an indefinite carryover for affected non-oil-related losses, a provision has been included to recapture any such pre-1983 non-oil-related losses from oil-related income over eight years, to the extent they have not otherwise been recaptured.

The second major change gives the Secretary of the Treasury authority to disallow credits for foreign taxes where the foreign law imposing the tax is structured or, in fact, operates to impose abnormally higher taxes on oil-related income than on other types.

Third, TEFRA requires that net extraction losses from one country be offset against extraction income from other countries for purposes of computing the amount of creditable oil and gas extraction taxes.

The final change repeals the 2 percent limitation on carrybacks and carryovers of excess foreign oil and gas extraction taxes.

In general, the changes to the foreign tax credit rules applicable to oil and gas activities are effective for taxable years beginning after 1982.

SUBPART F COVERAGE OF FOREIGN OIL AND GAS NONEXTRACTION INCOME

Generally, foreign corporations are not subject to U.S. taxation on foreign-source income that is not effectively connected with the conduct of a U.S. trade or business. However, certain U.S. shareholders of controlled foreign corporations (CFCs) may be taxed, under the antiavoidance provisions of Internal Revenue Code Subpart F, on their proportionate share of corporate earnings from certain types of income perceived as promoting tax avoidance (Subpart F income).

TEFRA creates a new category of Subpart F income for foreign oil-related income. Under its provisions, U.S. shareholders of CFCs are currently subject to U.S. tax on the CFCs' foreign oil-related income arising from countries other than those in which the oil and gas are extracted or consumed. An exception applies where neither the controlled foreign corporation nor any related person has foreign oil or gas extraction income. This exception applies if the aggregate daily production of *foreign* crude oil and natural gas by the corporation and related persons for any taxable year is less than 1,000 barrels of oil or the equivalent in natural gas.

Unlike other types of Subpart F income, foreign oil-related income cannot be eligible for exemption from Subpart F, even if tax avoidance was not a significant motivating factor in the creation or organization of the controlled foreign corporation.

The amendment to the Subpart F provisions applies to taxable years of foreign corporations beginning after 1982, and to taxable years of U.S. shareholders in which, or with which, such taxable years of their controlled foreign corporations end.

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